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March 6, 2007

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Marlene Dortch
Secretary
Federal Communications Commission
445 Twelfth St., SW
Washington, DC 20554

Re: *High Cost Universal Service Support*, WC Docket No. 05-337
Developing a Unified Intercarrier Compensation Regime, CC Docket No. 01-92
Federal-State Joint Board on Universal Service, CC Docket No. 96-45
Western Wireless Corp. Petition for Rulemaking, Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers, RM-10822

Dear Ms. Dortch:

Alltel Corp. ("Alltel") submits this letter with regard to the attached Petition for Rulemaking filed on October 30, 2003 by Alltel's predecessor, Western Wireless Corp. *See Western Wireless Corp. Petition for Rulemaking, Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers*, RM-10822 (filed Oct. 30, 2003) ("*WW Petition*"). Alltel continues to maintain that, as set forth in the *WW Petition*, the existing system of rate-of-return regulation of rural telephone companies is contrary to the public interest, and should be phased out in the context of high-cost universal service and intercarrier compensation.

However, Alltel requests that, rather than considering the *WW Petition* in a separate Petition for Rulemaking docket (RM-10822), that separate docket should be closed. Instead, the Commission should continue to consider these issues in the pending proceedings on high-cost universal service (WC Docket No. 05-337) and intercarrier compensation reform (CC Docket No. 01-92). 1/ Alltel respectfully submits that the *WW Petition* and the comments and reply

1/ We note that these issues are already under consideration in the FCC's high-cost universal service and intercarrier compensation rulemaking dockets. *See Federal-State Joint Board on Universal Service*, Order and Referral to Joint Board, CC Docket No. 96-45, FCC 04-125, 19 FCC Rcd 11538, ¶ 11 n.29 (2004) (noting the *WW Petition* and referring related issues for consideration by the Joint Board); *Federal-State Joint Board on Universal Service Seeks Comment on Certain of the Commission's Rules Relating to High-Cost Universal Service Support*, Public Notice, CC Docket No. 96-45, FCC 04J-2, 19 FCC Rcd 16083 (Joint Board 2004) (seeking comment on issues referred to the Joint Board, including whether high-cost support for rural incumbent local exchange carriers

comments thereon should be incorporated by reference into the record of these pending proceedings.

Please contact me if you have any questions about this filing.

Respectfully submitted,

David L. Sieradzki
Counsel to Alltel

Enclosures

cc: Thomas Navin
Albert Lewis
Jeremy Marcus

and competitive eligible telecommunications carriers should be based on forward-looking economic costs rather than embedded costs); *Developing a Unified Intercarrier Compensation Regime*, Further Notice of Proposed Rulemaking, CC Docket No. 01-92, 20 FCC Rcd 4685, ¶¶ 54-55 & n.189 (2005) (seeking comment on Western Wireless intercarrier compensation reform plan and noting relationship to proposals in the *WW Petition*).

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers	)	RM-____
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Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
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PETITION FOR RULEMAKING TO ELIMINATE RATE-OF-RETURN REGULATION OF INCUMBENT LOCAL EXCHANGE CARRIERS

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October 30, 2003

Western Wireless Petition for Rulemaking
To Eliminate Rate-of-Return Regulation of ILECs

Top Ten Reasons to Eliminate Rate-of-Return ("ROR") Regulation

1. **Save Money.** By far the largest cause of the growth of the high-cost universal service fund is disbursements to rural ILECs pursuant to ROR formulas. Consumers across the country would save hundreds of millions, possibly billions, of dollars if ROR were eliminated and replaced with a system better targeted to support affordable service for consumers in high-cost areas.

2. **Stop Waste, Fraud and Abuse.** Regulators and independent auditors rarely, if ever, look at the accounting books of most ROR carriers, and opportunities abound for carriers to overstate their costs and thereby increase their access charges and high-cost support. The Supreme Court recognized that the ILECs' "book costs may be overstated by approximately $5 Billion." [*Verizon v. FCC*, 535 U.S. 467, 518 (2002)]

3. **Prevent Cross-Subsidies and Cost Misallocation.** In the few cases where the FCC or a state commission examined carriers cost submissions, they found millions of dollars of misallocated costs, including costs of unregulated affiliates assigned to the ILEC in order to inflate high-cost support. In most cases, the FCC may lack authority to order remedies for such over-earnings. "In an era of corporate governance problems and accounting depredations," [Adelstein/Copps statement, FCC 03-111, 5/19/03], the FCC should change the rules to eliminate the rewards for such anti-competitive misconduct.

4. **Create Incentives for Efficiency.** ROR regulation gives carriers incentives "to adopt the most costly, rather than the most efficient, investment strategies," [3 FCC Rcd 3195, 3219-20]. Ending ROR would create incentives for more efficient networks, and would benefit consumers.

5. **Enhance Incentives for Innovation.** The FCC has recognized that ROR "may have a negative effect on innovation . . . . because a carrier's reward for such innovation is a reduction in its dollar earnings." [3 FCC Rcd 3195, 3223]. Eliminating ROR regulation would enhance incentives to speed the deployment of new technologies, benefitting rural consumers.

6. **Remove Barriers to Competition in Rural Areas.** Rural customers benefit from access to competitive telecom alternatives, but ROR regulation is a barrier to full competition. ROR targets RLECs' revenues to achieve a guaranteed return on investment on all historical costs incurred, while the RLECs' competitors receive portable funding only if they can obtain ETC designation, and even then only with respect to the lines that they provide – and unlike the RLECs, competitive carriers' investments are at risk.

7. **Fix Distorted Intercarrier Compensation.** Eliminating ROR would enable the FCC to remove implicit subsidies from the RLECs' access rates, as the Act requires.The RLECs' current, unreasonably high access charges distort local and long-distance competition in rural areas, deprive rural consumers of access to long-distance alternatives, and interfere with the development of a comprehensive, rational system of intercarrier compensation.

8. **Rationalize and Modernize High-Cost Support.** The current high-cost support system is an irrational hodge-podge that gives rural ILECs vastly more support than larger carriers for serving

identical geographic areas, rewards them simply for being small, and ignores whether they are efficient or not. The ROR paradigm must be replaced with a competitively neutral system that ensures "sufficient funding of *customers*, not *providers*," as the 1996 Act requires. [*Alenco*, 201 F.3d 608, 620 (5th Cir. 2000).]

9. **Remedy Unhealthy Dependence of RLEC Sector.** Many RLECs receive 70% or more of their funding from universal service subsidies or intercarrier payments, rather than from their own customers. This unhealthy dependence insulates these carriers from any incentive to be responsive to their own consumers' needs. Eliminating ROR and rebalancing rates would put these carriers on a healthier financial footing.

10. **The FCC Was Correct and Should Keep Its Promises.** In the 2001 *RTF Order*, the FCC reaffirmed its 1997 commitment to adopting forward-looking cost-based support mechanisms for rural carriers. It is time for the Commission to deliver on this worthy commitment.

In sum, ROR regulation bloats the universal service fund, creates opportunities and incentives for waste, fraud and abuse, and inhibits the development of efficient, innovative, and competitive services for rural consumers. ROR regulation has outlived its time and must be replaced with a more appropriate form of regulation based upon today's competitive environment.

* * * * *

Western Wireless proposes to replace ROR regulation with a forward-looking cost-based system to determine universal service high-cost support and access charge rate levels:

- **Cost Methodology.** Develop a model or other cost analysis methodology that accurately estimates the forward-looking cost of wireline service in high-cost areas. Develop a similar model or other methodology to estimate the forward-looking cost of *wireless* service. Support would be based on the lower of the wireline or wireless forward-looking cost in each geographic area.

- **Support Methodology.** Provide two types of support: the first based on a simple comparison of the cost of service with a national benchmark, and the second based on statewide averages. As an inducement to rate rebalancing and eliminating implicit subsidies in retail rates, limit support to carriers with retail rates that are below minimum "affordable" levels.

- **Phase In the New System.** Implement the new rules in 2006 (at the end of the 5-year period provided by the *RTF Order*) for competitive ETCs, non-rural ILECs, and rural ILECs owned by relatively large holding companies. Phase in the rules over the following 6 years for smaller rural ILECs.

- **Establish "Safety Net" and "Hold Harmless" Mechanisms.** To avoid rate shock, implement the plan so that no study area loses more than a specified percentage of the amount of support it previously received in any one year. Offer additional support if a carrier can prove that the forward-looking support amount is insufficient given its particular circumstances.

- **Reform Access Charges.** Rebalance access charges by moving non-traffic sensitive costs and other implicit subsidies out of access charges paid by long-distance carriers, and into subscriber line charges. Set RLEC access rates based on forward-looking costs, price cap mechanisms, and/or generic intercarrier compensation rules.

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PETITION FOR RULEMAKING TO ELIMINATE RATE-OF-RETURN REGULATION OF INCUMBENT LOCAL EXCHANGE CARRIERS

Western Wireless Corporation ("Western Wireless"), by counsel and pursuant to Section 1.401 of the Commission's rule, hereby submits this Petition for Rulemaking to eliminate rate-of-return ("ROR") regulation of rural incumbent local exchange carriers ("RLECs"), for purposes of determining their federal high-cost universal service support and interstate access charges. This petition seeks to facilitate the transformation of the local telecommunications market from a monopoly to a competitive environment by replacing a highly inefficient, non-competitive system of regulation with an efficient, competitively neutral approach to regulating RLECs. By granting this Petition, the Commission will release rural consumers from the monopoly grips of the RLECs, whose dominant position in the local market threatens the ability of rural America to have access to basic and advanced services comparable to those available in urban areas.

As the Commission has previously recognized "rate of return regulation provides regulated firms with very strong incentives to pad their rates," leads them "to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base," and "may have a negative effect on innovation . . . . because a carrier's reward for such innovation is a reduction in its dollar earnings." 1/ Moreover, ROR regulation is based on an outdated monopoly paradigm of guaranteeing that a favored group of carriers "recover their investment in the total network facilities needed . . . ." 2/ This paradigm of protecting selected carriers' investments must be replaced with a paradigm of ensuring "sufficient and competitively-neutral funding to enable all customers to receive basic telecommunications services," since the 1996 Act "requires sufficient funding of *customers*, not *providers*." 3/ ROR regulation has outlived its time and must be replaced with a more appropriate form of regulation based upon today's competitive environment.

I. INTRODUCTION AND SUMMARY

Western Wireless provides commercial mobile radio service ("CMRS") in 18 Metropolitan Statistical Areas ("MSAs") and 88 Rural Service Areas ("RSAs")

1/ *Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3219-20, 3223, ¶¶ 39, 46 (1988) ("*Price Cap FNPRM*").

2/ National Telecommunications Cooperative Association ("NTCA") Initial Comments, CC Docket No. 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 7.

3/ *Alenco Communications, Inc. v. FCC*, 201 F.3d 608, 620 (5th Cir. 2000) ("*Alenco*") (emphasis in original).

in 19 states. The Company has also been designated as an eligible telecommunications carrier ("ETC") in 14 states, plus the Pine Ridge Indian reservation. More and more consumers today rely on wireless services for the telecommunications needs. Wireless and wireline services are becoming largely interchangeable, with both services increasingly competing to serve a consumer's telecommunications needs. The ability of Western Wireless to effectively compete with the RLECs is seriously compromised by a system of regulation – Rate-of-Return regulation – that essentially guarantees the RLECs' dominant position in the marketplace.

Western Wireless, like any business in a competitive environment, takes investment risks and receives revenues only to the extent that it is able to attract customers. By contrast, RLECs are the beneficiaries of ROR regulation that provides them a perceived entitlement to recover all their operating expenses and depreciation on capital expenditures, plus a specified rate of return on investment. Western Wireless and other competitive carriers operate in a much different market, a market without entitlements, guarantees, or immunity from marketplace forces. In the competitive market in which Western Wireless operates, consumers determine a carrier's fate.

As explained below, ROR regulation disserves the public interest by inhibiting competition, enabling incumbent carriers to maintain a dominant position in the local exchange market, and creating an inefficient universal service

funding mechanism that is growing too fast and exposes the public to serious risks of fraud and abuse.

First, the system of ROR regulation, designed for a monopoly environment, has no place in an environment of local competition. The ROR system targets RLECs' access rates and high-cost support to achieve a guaranteed return on investment on all historical costs incurred, while RLECs' emerging ETC competitors receive funding only on a per-line basis for those lines served. Unlike incumbent carriers, competitive entrants' investments are at risk. ROR regulation's reliance on the RLECs' historical costs is also inconsistent with the advent of local competition, since – as the Commission has long recognized, and as the Supreme Court recently affirmed, forward-looking costs are the only true measure of the factors that drive economic decision-making.

Second, as the Commission has repeatedly recognized, ROR regulation interferes with incentives for carriers to operate efficiently, deploy new technologies, and reduce their operating costs. In today's increasingly competitive environment, it makes no sense to retain a system that gives carriers incentives to operate inefficiently and discourages them from introducing technological innovations. The ROR system, which rewards carriers for being small and inefficient, also creates artificial and inefficient incentives for RLECs to remain as small as possible, and for larger ILECs to sell exchanges to smaller carriers, even if

it would be economically efficient for RLECs to combine or for larger carriers to operate those exchanges. 4/

Third, ROR regulation is the true cause for the growth of the high-cost universal service fund, which threatens the long-term viability of the fund. A universal service funding mechanism based upon ROR regulation, the almost complete lack of independent oversight over the RLECs' cost reporting, and legal restrictions on the Commission's ability to require refunds or other remedies if and when it detects ROR over-earnings, leaves the public exposed to a very serious risk of fraud, waste, and abuse. In this "era of corporate governance problems and accounting depredations," 5/ this risk should be unacceptable. 6/

This petition proposes eliminating and replacing ROR regulation of the larger RLECs beginning in 2006, and of smaller carriers over a gradual transition

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4/ Ideally, regulation should neither create incentives for concentration nor create incentives for de-concentration, but should allow the marketplace to determine the optimal size of telecommunications carriers.

5/ *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements,* Further Notice of Proposed Rulemaking, WC Docket No. 02-112, FCC 03-111 (released May 19, 2003) (separate statement of Commissioner Michael J. Copps and Commissioner Jonathan S. Adelstein, concurring). *See also 2002 Regulatory Review – Requirements Governing the NECA Board of Directors under Section 69.602 of the Commission's Rules and Requirements for the Computation of Average Schedule Payments under Section 69.606 of the Commission's Rules*, Report and Order, CC Docket No. 01-174, FCC 03-151 (released July 3, 2003) (statement of Commissioner Michael J. Copps, dissenting).

6/ In Attachment A to this Petition ("Rate of Return Regulation: Problems That Can No Longer Be Ignored") we supply evidence of such malfeasance that state commissions in California, Kansas, and other states have identified. This information builds on additional evidence in a report submitted with Western Wireless' Reply Comments filed June 3, 2003 in the *Joint Board Portability Proceeding*, and included as Attachment B to this Petition ("Rate of Return Regulation: A Failed Model for Economic Regulation"). Moreover, record evidence already before the FCC shows that ROR ILECs earned at least $400 million of dollars in excess of what the existing ROR system allows over the past few years. *See* AT&T Ex Parte Filing, CC Docket Nos. 00-256, 96-45, 98-77, and 98-166 (filed May 9, 2003).

period in subsequent years. This petition also calls for instituting extensive new safeguards during the transitional time period during which ROR will remain in effect. The time is right for a rulemaking to replace ROR regulation, particularly in light of the following closely related, pending and soon-to-be-initiated rulemaking proceedings:

- First, the rulemaking proposed here is closely related to the pending *Joint Board Portability Proceeding*, which addresses "the methodology for calculating support for ETCs" – including incumbent as well as competitive ETCs – "in competitive study areas." 7/ This rulemaking proceeding would develop a comprehensive record for the establishment of a new high-cost support system for all ETCs in lieu of ROR regulation and would be helpful in addressing issues in the pending *Joint Board Portability Proceeding*. Given the relationship among these issues, Western Wireless would support a referral to the Federal-State Joint Board on Universal Service of many of the issues discussed here. Western Wireless would also support referral of related separations issues to the Federal-State Joint Board on Separations.

- Second, the rulemaking sought here raises issues that are highly relevant to the forthcoming "comprehensive review of the high-cost mechanisms for rural and non-rural carriers as a whole," in which the Commission has committed to "consider all options, including the use of forward-looking costs, to determine appropriate support levels for both rural and non-rural carriers." 8/

- Third, the rulemaking sought here dovetails with the Further Notice of Proposed Rulemaking accompanying the *Tenth Circuit Remand Order*, in which the Commission seeks comment on additional targeted federal support to advance the goal that "states [ ] be encouraged to replace implicit support with explicit support mechanisms that will be sustainable in a competitive environment," which should help "achieve Congress' universal service goals by creating an explicit support fund

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7/ *Portability Referral Order*, 17 FCC Rcd at 22645-46, ¶ 7; *Joint Board Portability Public Notice*, 18 FCC Rcd at 1948, ¶ 15

8/ *Federal-State Joint Board on Universal Service*, Fourteenth Report and Order, 16 FCC Rcd 11244, 11310, ¶ 169 (2001) ("*RTF Order*").

to benefit consumers who need it and by eliminating the vestiges of implicit support that misallocate resources and distort competition." 9/

- Fourth, a rulemaking proceeding to eliminate ROR regulation will help the Commission achieve its objectives with regard to intercarrier compensation. 10/ Eliminating ROR regulation of the RLECs' access charges will enable the Commission to eradicate the implicit subsidies currently embedded in those rates, as the Act requires. 11/ It will also help the Commission to end the economic distortions in the local and long-distance marketplace caused by the RLECs' excessive access rates.

- Finally, the recently opened Total Element Long-Run Incremental Cost ("TELRIC") review proceeding will address forward-looking costing questions that may also be relevant to the development of a new forward-looking cost-based universal service support system for RLECs, non-rural incumbent carriers and competitive ETCs. 12/

9/ *Federal-State Joint Board on Universal Service,* Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order, CC Docket No. 96-45, FCC 03-249, ¶ 127 ("*Tenth Circuit Remand Order FNPRM*") (released Oct. 27, 2003); *id.*, Separate Statement of Chairman Michael K. Powell, at 1.

10/ *Developing a Unified Intercarrier Compensation Regime*, Notice of Proposed Rulemaking, 16 FCC Rcd 9610 (2001) ("*Intercarrier Compensation Notice*"). The *Intercarrier Compensation Notice* specifically sought comment on moving the access charges of all local exchange carriers, including RLECs subject to ROR regulation, toward a bill-and-keep system. *Id.*, 16 FCC Rcd at 9644-45, ¶ 97. It also addressed the possible impact of such reforms on end-user rates and universal service support mechanisms. *Id.*, 16 FCC Rcd at 9654-55, ¶¶ 123-24.

11/ *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 406 (5th Cir. 1999); *Alenco*, 201 F.3d at 624; *Texas Office of Public Utility Counsel v. FCC*, 265 F.3d 313, 318 (5th Cir. 2001).

12/ *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Services by Incumbent Local Exchange Carriers,* Notice of Proposed Rulemaking, 18 FCC Rcd 18945 (2003) ("*TELRIC NPRM*"). To be sure, the forward-looking economic cost methodology used for pricing network elements is different in important respects from the forward-looking economic cost model used in the context of universal service support, and the two methodologies need not be identical. *TELRIC NPRM*, ¶ 46; *Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 FCC Rcd 20156, 20172, ¶ 32 (1999) ("*USF Inputs Order*"), *aff'd sub nom. Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001). Nonetheless, there are important methodological and input questions that could affect both network element pricing and universal service, in particular the models and inputs used to determine forward-looking costs.

We offer herein a brief history of ROR regulation, including the FCC's stated commitment to transition all high-cost universal service support to a forward-looking system. Next, we provide more detailed support for why the obsolete and anti-competitive system of ROR regulation should be brought to an end as expeditiously as possible. We discuss possible replacements for ROR regulation, including a forward-looking economic cost-based system to set high-cost universal service funding amounts in rural areas, and rate rebalancing and an overhaul of RLEC access charges as part of comprehensive intercarrier compensation reform. Finally, we offer a transition plan for phasing out ROR regulation and introducing a system of regulation based on forward-looking economic cost.

As demonstrated herein, ROR regulation has outlived its usefulness. Now is the time for the Commission to initiate a rulemaking proceeding to eliminate ROR regulation of the RLECs and replace it with a new system based on forward-looking economic costs.

II. BACKGROUND

A. Rate-Of-Return Regulation Has Its Historical Roots In The Era Of Monopoly Local Telephone Service That No Longer Exists

ROR regulation based on historical, embedded costs was first introduced in the context of regulating a monopoly power company's return on investment. In 1944, the Supreme Court upheld the Federal Power Commission's decision to use ROR regulation based on historical costs, and rejected a utility's argument that the agency should have used a "fair value" (based on reproduction costs) methodology (one form of what is now referred to as a forward-looking

economic cost methodology). 13/ The Supreme Court, however, specifically rejected the notion that ROR is the only legally permissible approach to regulating even in a monopoly environment:

> It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. * * * * [T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates. 14/

The FCC did not begin to formally develop its ROR system for regulating the then-monopoly incumbent local exchange carriers ("ILECs") until the mid-1960s, and conducted a number of major ROR ratemaking proceedings regarding the Bell System during the 1960s, 1970s and early 1980s. 15/ However, the Commission never directly regulated the costs or rates of the small and mid-size ILECs (also known as "independent" carriers because they were not affiliated with the pre-divestiture Bell system). Prior to divestiture, the independent ILECs

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13/ *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

14/ *See id.* at 602, 609. *See also Duquesne Light Co. v. Barasch,* 488 U.S. 299 (1989); *Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 497-501 (2002) ("*Verizon v. FCC*") (affirming FCC's use of forward-looking costs as the basis for setting UNE rates); *Alenco*, 201 F.2d at 620 ("The Act only promises universal service, and that is a goal that requires sufficient funding of *customers*, not *providers*. So long as there is sufficient and competitively-neutral funding to enable all customers to receive basic telecommunications services, the FCC has satisfied the Act and is not further required to ensure sufficient funding of every local telephone provider as well.") (emphasis in original).

15/ *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2884-89, ¶¶ 18-28 (1989) ("*AT&T Price Cap Order*") (describing history of ROR regulation).

received a share of long-distance revenues from the monopoly long-distance carrier, AT&T, through a "settlements" process that was "industry devised" and barely, if at all, overseen by the Commission. 16/ The ILECs simply reported their costs to AT&T or its Bell company affiliates, which reviewed their cost studies, albeit with no independent regulatory oversight, and a settlement amount was negotiated.

What the Commission *did* oversee, beginning in the 1960s, was the Separations Manual, which controlled the allocation of costs between the state and interstate jurisdictions. 17/ The Separations Manual was utilized as an elaborately complex mechanism to funnel implicit universal service subsidies from long-distance to local rates. 18/ The separations rules (now in Part 36) continue to serve that purpose to this day.

The system of "division of revenues" and "settlements" became unsustainable with the emergence of long-distance competition. Thus, the FCC replaced that system with access charges, and created the National Exchange Carrier Association ("NECA"), consisting of ILEC members and run by the ILECs'

16/ *MTS and WATS Market Structure*, Notice of Inquiry and Notice of Proposed Rulemaking, 67 FCC 2d 757, 759, ¶ 8 (1978). Similarly, AT&T's ILEC affiliates – the Bell Operating Companies – received a share of long-distance revenues through a "division of revenues" process.

17/ *See American Telephone & Telegraph Co. and the Associated Bell System Companies Charges for Interstate and Foreign Communication Service*, 9 FCC 2d 30, 90, ¶ 246 (1967) (first Commission order addressing separations rules) ("Although the content of the 'Separations Manual' is the product of cooperative studies and consultations involving the NARUC, this Commission, and the telephone industry, [prior to this order] it has never been formally evaluated, approved, or adopted by this Commission in the context of either a ratemaking or rulemaking proceeding.")

18/ *See generally* P. Huber, M. Kellogg, and J. Thorne, *Federal Telecommunications Law* 130-40 (2d. ed. 1999).

representatives, 19/ to take over certain functions previously handled by AT&T: tariff coordination, monitoring of individual ILECs' cost studies, development of averaged rates, and pool administration. No independent regulatory authority ever thoroughly reviewed the cost submissions by the small, independent ILECs, although the FCC exercised a degree of oversight over NECA's tariff filings and other operations.

Gradually, the rules were relaxed, and the larger ILECs were permitted to exit from NECA's rate pools and averaging. However, three mechanisms were established to preserve the pre-divestiture subsidies that the small, independent ILECs had enjoyed under the old "settlements" system. After the 1996 Act was enacted, contributions from the telecommunications carriers became the source of funding for these mechanisms (replacing some, but not all, of the interstate access charges paid by long-distance carriers). The disbursement rules for rural ILECs, however, remain essentially the same as they were prior to 1996, with only minimal exceptions, such as:

- First, for rural ILEC study areas that reported loop costs that were above the national average, the ILEC was allowed to recover a significantly higher proportion of its loop costs than it would have received under the standard separations rules. This mechanism, originally known simply as the "Universal Service Fund," survives today as "High-Cost Loop" support, and amounts to over $1.1 billion annually. 20/

19/ *See* 47 C.F.R. Part 69, Subpart G (rules governing NECA membership and board).

20/ *See* 47 C.F.R. Part 36, Subpart F. The support amounts listed in this and the following text are drawn from the Universal Service Administrative Co.'s 4th quarter 2003 filings with the FCC, available at http://www.universalservice.org/overview/filings/.

- Second, for rural ILEC study areas with very small numbers of lines (regardless of the total number of lines provided by the holding company's other affiliates), the ILEC was also permitted to recover increased access charges. This was originally implemented through a tweak in the jurisdictional separations rules known as Dial Equipment Minutes ("DEMs") Weighting, which assigned a significantly higher proportion of those ILECs' switching costs into the interstate jurisdiction than would have been justified by their relative interstate switch usage. This "DEMs Weighting" mechanism survives today as "Local Switching Support," amounting to over $400 million per year. 21/

- Third, low-cost ILECs that departed from the NECA cost-averaging pools were required to make payments into the pools to support the high-cost ILECs remaining in the pools. These payments, which were phased down during the 1990s but never entirely eliminated, survive today as "Long Term Support," and amount to over $500 million annually. 22/

While the Commission has adopted some reforms to the RLECs' interstate access charge structure, such as reducing those charges from their pre-existing, absurdly high levels to levels that are still high, but more closely approaching those charged by larger ILECs, the ROR system remains the basis for setting the RLECs' access rates. In fact, in order to perpetuate the ROR regulatory system, the Commission established the Interstate Common Line Support ("ICLS") fund, targeted to guarantee revenue neutrality for the RLECs at the time of access charge reform. 23/ The ICLS fund distributes over $400 million annually.

21/ *See* 47 C.F.R. § 54.301.

22/ *See* 47 C.F.R. § 54.303.

23/ *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, 16 FCC Rcd 19613 (2001) ("*MAG Order*"), *subsequent history omitted*; *see also* 47 C.F.R. Part 54, Subpart K.

By contrast, the Commission long ago eliminated ROR regulation for AT&T and the large ILECs, and replaced that system with price cap regulation. In that proceeding (discussed at greater length below), the Commission found that ROR regulation gives regulated carriers inefficient investment incentives, impedes innovation, and creates opportunities for carriers to pad their expenses and misallocate costs in order to improperly increase their revenues. On this basis, the Commission decided to eliminate ROR regulation as the basis for AT&T's long-distance rates in 1989, and as the basis for the large ILECs' interstate access charges in 1990. 24/ State commissions shared the FCC's aversion to ROR regulation of telecommunications carriers, and all but six of them have abolished ROR for the Bell Operating Companies. 25/

In enacting the 1996 Act, Congress specifically rejected ROR as the basis for setting rates for unbundled network elements ("UNEs"): Section 252(d)(1)(A)(i) directs the FCC and state commissions to set rates for interconnection and network elements "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element . . . ." 26/ To be sure, the Commission has made it clear that the methodology for setting UNE rates differs from that used for

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24/ *See AT&T Price Cap Order, supra*; *ILEC Price Cap Order, supra.*

25/ National Regulatory Research Institute, *Retail Regulation of Local Telecommunications Providers (as of April 2002)*, Jan. 2003, available at http://www.nrri.ohio-state.edu/programs/markets/pdf/reg-regime-adoption-by-state-map.pdf.

26/ 47 U.S.C. § 252(d)(1)(A)(i).

determining universal service support. 27/ Nonetheless, it is notable that the Supreme Court, in upholding the Commission's initial order rejecting the use of embedded costs in setting UNE rates, specifically noted the problematic nature of ROR regulation. 28/ The Commission again "reaffirm[ed] [its] commitment to forward-looking costing principles" and declined to open any inquiry into "alternative pricing methodologies that rely in whole or in part on embedded costs" in its recent *TELRIC NPRM*. 29/

B. The Commission Has Repeatedly Committed to Transitioning High-Cost Universal Service Support To A Forward-Looking Cost-Based System.

In implementing the 1996 Act's universal service policy, the Commission has repeatedly committed itself to eliminating the pre-1996 high-cost mechanisms based on embedded costs and ROR regulation, and replacing them

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27/ *TELRIC NPRM*, ¶ 46; *USF Inputs Order*, 14 FCC Rcd 20156, 20172, ¶ 32.

28/ *Verizon v. FCC*, 535 U.S. at 512 ("[T]he temptation would remain to overstate book costs to ratemaking commissions and so perpetuate the intractable problems that led to the price-cap innovation."); *id* at 517-18 ("the 'book' value or embedded costs of capital presented to traditional ratemaking bodies often bore little resemblance to the economic value of capital"); *id.* at 518 ("[B]ook costs may be overstated by approximately $5 billion.") (*quoting FCC Releases Audit Report on RBOCs' Property Records,* Report No. CC 99-3 (rel. Feb. 25, 1999). *See also TELRIC NPRM*, ¶ 40 n.82; *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499, 15846, ¶ 679 (1996) ("*Local Competition Order*"), *subsequent history omitted* ("Adopting a pricing methodology based on forward-looking, economic costs best replicates, to the extent possible, the conditions of a competitive market. In addition, a forward-looking cost methodology reduces the ability of an incumbent LEC to engage in anti-competitive behavior.").

29/ *TELRIC NPRM*, ¶¶ 29, 37. *See also id.*, Separate Statement of Chairman Michael K. Powell ("*[O]ur commitment to retaining a forward-looking approach is unwavering* – what we are debating is the extent to which realistic assumptions about the incumbent's network should be included in our pricing rules.") (emphasis added); Separate Statement of Commissioner Kevin J. Martin ("I believe that the prices for unbundled network elements should be based on the *forward-looking* replacement cost of the ILEC's network.") (emphasis added).

with high-cost support based on forward-looking cost. In the *Universal Service First Report and Order*, the Commission concluded that the pre-1996 mechanisms "neither ensure that ILECs are operating efficiently nor encourage them to do so" and are "contrary to sound economic policy." 30/ The Commission found that, for small rural carriers as well as for non-rural carriers, "basing support on forward-looking economic cost . . . will require telecommunications carriers to operate efficiently and will facilitate the move to competition in all telecommunications markets." 31/ The Commission elaborated on its view that a forward-looking mechanism would be consistent with the Act and better serve the statutory objectives:

> Consistent with the Joint Board's recommendation, we anticipate, however, that forward-looking support mechanisms that could be used for rural carriers within the continental United States will be developed within three years of release of this Order. We conclude that a forward-looking economic cost methodology consistent with the principles we set forth in this section should be able to predict rural carriers' forward-looking economic cost with sufficient accuracy that carriers serving rural areas could continue to make infrastructure improvements and charge affordable rates. Like the Joint Board, we conclude that calculating support using such a forward-looking economic cost methodology would comply with the Act's requirements that support be specific, predictable, and sufficient and that rates for consumers in rural and high cost areas be affordable and reasonably comparable to rates charged for similar services in urban areas. Moreover, such a mechanism could target support by calculating costs over a smaller geographical area than the study areas currently used. In addition, we find that the use of mechanisms incorporating forward-

30/ *Federal-State Joint Board on Universal Service*, First Report and Order, 12 FCC Rcd 8776, 8934-35, ¶ 292 (1997) ("*Universal Service First Report and Order*"), *subsequent history omitted. See also id.* at 8934-35, ¶ 292 ("Indeed, by guaranteeing carriers recovery of 100 percent of all loop costs in excess of 150 percent of the national average loop cost, the current high-cost funding mechanisms effectively discourage efficiency.").

31/ *Id.*

> looking economic cost principles would promote competition in rural study areas by providing more accurate investment signals to potential competitors. 32/

The Commission reaffirmed its long-term commitment to the use of forward-looking costs to set universal service support levels in its recent *RTF Order*. The Commission specifically stated that it "disagree[d]" with rural ILEC representatives who argued "that the forward-looking cost mechanism should not be used to determine rural company support and that only an embedded cost mechanism will provide sufficient support for rural carriers." 33/ Rather, the Commission reaffirmed its previous conclusions regarding the transition from a universal service system based on rate-of-return to one based on forward-looking costs:

> The Commission previously determined that support based on forward-looking cost is sufficient for the provision of the supported services and sends the correct signals for entry, investment, and innovation. . . . While the Rural Task Force demonstrated the inappropriateness of using input values designed for non-rural carriers to determine support for rural carriers, we do not find that its analysis justifies a reversal of the Commission's position with respect to the use of forward-looking cost as a general matter. 34/

The Commission indicated that it would soon initiate a "comprehensive review of the high-cost mechanisms for rural and non-rural carriers as a whole," in which it

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32/ *Id.* at 8935, ¶ 293. The Commission, however, declined to move rural ILECs immediately into a forward-looking cost-based system immediately due to concerns about the applicability of the cost models to rural ILECs. *Id.* at 8935-37, ¶¶ 294-95.

33/ *RTF Order*, 16 FCC Rcd at 11311, ¶ 174 (2001) (emphasis added)(citations omitted).

34/ *Id. Accord, Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 412 (5th Cir. 1999) (affirming that forward-looking support satisfies statutory "sufficiency" criterion); *Alenco* , 201 F.3d at 620 (same).

would "consider all options, including the use of forward-looking costs, to determine appropriate support levels for both rural and non-rural carriers." 35/

It is time for the Commission to deliver on these commitments. The Commission should promptly open the rulemaking Western Wireless proposes, and should work toward eliminating ROR regulation and replacing it with a system based on forward-looking costs.

III. THE FAILED SYSTEM OF RATE-OF-RETURN REGULATION MUST BE ELIMINATED AND REPLACED EXPEDITIOUSLY

In adopting the 1996 Act, Congress challenged regulators to adopt a new regulatory paradigm that would be consistent with the emergence of competition throughout the telecommunications industry, including in rural and high-cost areas, while also preserving and advancing the goal of universal service. Up to now, the Commission has delayed the inevitable changes to the ROR system of regulating RLECs, perhaps due to concerns about the impact of this competitive transformation on rural carriers and their customers and the need for a gradual transition. However, the time has come to begin making the changes necessary to focus universal service policy on "sufficient funding of *customers*, not *providers*." 36/

As discussed below, the existing ROR system is pernicious for three reasons: (1) it precludes the development of competition on a level playing field, and thereby harms consumers in rural areas who are deprived of the benefits of

35/ *RTF Order*, 16 FCC Rcd at 11310, ¶¶ 169-70.

36/ *Alenco,* 201 F.3d at 620 (emphasis in original).

such competition; (2) it gives carriers incentives to operate inefficiently and discourages them from introducing technological innovations, to the detriment of rural consumers; and (3) it creates opportunities for waste, fraud and abuse and causes the unwarranted expansion of the universal service fund, harming consumers nationwide who ultimately pay into the fund.

A. ROR Regulation Artificially Interferes With Competition

ROR regulation harms consumers in rural areas by artificially interfering with competition. Competition in the universal service market benefits consumers by "increasing customer choice, innovative services, and new technologies," by promoting "the deployment of new facilities and technologies" while providing "an incentive to the incumbent rural telephone companies to improve their existing network to remain competitive," and by "creating incentives to ensure that quality services are available at 'just, reasonable, and affordable rates.' " 37/ But such competition on a level playing field is impossible under the current ROR rules.

First, the current funding mechanism asymmetrically provides full historical cost recovery for incumbents, but per-line recovery for new entrants. It thereby creates a bias in favor of the incumbent. This can distort competitive outcomes and reduces economic efficiency. There can be no level competitive playing field when the incumbent not only enjoys the natural advantages of

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37/ *Federal-State Joint Board on Universal Service; Western Wireless Corp. Petition for Designation as an Eligible Telecommunications Carrier in the State of Wyoming*, 16 FCC Rcd 48, 56, ¶ 17 (Com. Car. Bur. 2000), *aff'd*, 16 FCC Rcd 19144 (2001).

incumbency, but also enjoys a government-guaranteed return on investment, while competitive ETCs' investments are completely at risk. ROR regulation provides revenue guarantees for ILECs, but not competitive ETCs, which is fundamentally antagonistic to competition. 38/

Second, ROR concepts drive a fundamentally unbalanced high-cost regime for rural ILECs and competitive ETCs. Rural ILECs are assured a particular level of support even if they lose access lines and market share to a competitor. The Commission originally adopted a rule that would have taken support away from ILECs as competitive ETCs gain market share, but abandoned this competitive market-based rule for a return to ROR regulation. 39/ Competitive ETCs receive support only for the customer connections they serve – that is, they receive support only to the extent they garner market share, and if they lose customers, they lose support. Competition on a level playing field is impossible when one class of competitors receives such unbalanced regulatory advantages. 40/

Third, ROR-based access charges and universal service support create inaccurate and inefficient incentives for competitive entrants, as well as for incumbent carriers. The Commission's recent condemnation of the use of historical

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38/ Rather than creating revenue guarantees for competitive ETCs as well, as some parties suggest, the Commission should eliminate such guarantees for all carriers.

39/ *Federal-State Joint Board on Universal Service*, Ninth Report and Order, 14 FCC Rcd 20432 (1999), *rev'd in part on other grounds sub nom. Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001). *See also* Rural Task Force, *RTF White Paper #5: Competition and Universal Service* at 16 (Sept. 2000) (available at http://www.wutc.wa.gov/rtf).

40/ *See Western Wireless Corp. Petition for Preemption of Statutes and Rules Regarding the Kansas State Universal Service Fund Pursuant to Section 253 of the Communications Act of 1934*, 15 FCC Rcd 16227, 16231, ¶ 10 (2000).

costs in UNE rate setting applies with equal force to the use of historical costs in setting rural ILECs' access charge rates and universal service support levels:

> In addition to the problems associated with reliance on incumbent LEC accounting records, the use of historical costs does not necessarily provide efficient investment signals to potential entrants. As many economists have noted, it is forward-looking costs, not historical costs, that are relevant in setting prices in competitive markets. If historical costs are higher than the forward-looking costs an entrant would face, setting rates on the basis of historical cost could result in UNE prices that deter entry generally, or cause entrants to build their own facilities even when it is inefficient to do so. Conversely, if historical costs are lower than forward-looking costs, UNE rates based on historical costs might cause entrants to lease facilities when it was more efficient either to build their own or not to enter a particular market. 41/

B. ROR Regulation Creates Incentives for Inefficiency and Impedes Innovation

ROR regulation creates incentives for ILECs to operate inefficiently (even in a monopoly environment), because it entitles them to cost recovery regardless of how inefficient the investment. The Commission recognized this problem over ten years ago:

> First, as a profit-maximizer, the firm is led to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base. * * * Second, since all operating expenses are included in a firm's revenue requirement under rate of return, management has little incentive to minimize operating costs. * * * In both cases, . . . consumers suffer because these distorted incentives increase the cost of doing business – and thus the rates consumers must pay for service. * * * * *
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> The distorted efficiency incentives established by rate-of-return regulation also may have a negative effect on innovation. Clearly, rate-of-return establishes no incentive to 'do the same old thing a better

41/ *TELRIC NPRM* at ¶ 32.

> way' – for example, by providing the same service at lower cost – because a carrier's reward for such innovation is a reduction in its dollar earnings. Such regulation may well have similar effects on incentives to produce new products and services. 42/

The Commission expanded on this analysis in its 1989 order eliminating ROR regulation for AT&T and proposing to eliminate it for the large ILECs, concluding as follows:

> Under rate of return, however, "normal" profit levels are established in advance by regulatory fiat. The dynamic process that produces socially beneficial results in a competitive environment is strongly suppressed. In fact, rather than encourage socially beneficial behavior by the regulated firm, rate of return actually discourages it.
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> The distorted incentives created by rate of return regulation are easily illustrated. In a competitive environment, where prices are dictated by the market, a company's unit costs and profits generally are related inversely. If one goes up, the other goes down. Rate of return regulation stands this relationship on its head. Although carriers subject to such regulation are limited to earning a particular percentage return on investment during a fixed period, a carrier seeking to increase its dollar earnings often can do so merely by increasing its aggregate investment. In other words, under a rate of return regime, profits (*i.e.*, dollar earnings) can go up when investment goes up. This creates a powerful incentive for carriers to "pad" their costs, regardless of whether additional investment is necessary or efficient. And, because a carrier's operating expenses generally are recovered from ratepayers on a dollar-for-dollar basis, and do not affect shareholder profits, management has little incentive to conserve on such expenses. This creates an additional incentive to operate inefficiently. Moreover, in situations in which carriers providing more than one service face competition for one or more of such services, rate of return regulation enables carriers to distort the competitive process by manipulating their reported cost allocations.
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> A system that establishes such incentives is unlikely to encourage efficiency. Moreover, administering rate of return regulation in order

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42/ *Price Cap FNPRM,* 3 FCC Rcd at 3219-20, 3223, ¶¶ 39, 46; *see also* Harvey Averch and Leland L. Johnson, "Behavior of the Firm under Regulatory Constraint," 52 Amer. Econ. Rev. 1052 (1962; Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions*, vol. 2, at 47-59 (1971).

> to counteract these incentives is a difficult and complex process, even when done correctly and well. This is so primarily [because] . . . . a regulator may have difficulty obtaining accurate cost information as the carrier itself is the source of nearly all information about its costs. Furthermore, no regulator has the resources to review in detail the thousands of individual business judgments a carrier makes 43/

The Commission went on to observe the difficulty of preventing cost misallocations and cross-subsidies, particularly in an environment of technological advancement, increasing competition, and "a continuing shift in the boundaries between the competitive and less competitive segments of the telecommunications marketplace." 44/

Thus, rate of return regulation is widely recognized as eliminating incentives for carriers to operate efficiently, improve productivity, or introduce innovative technologies and services. 45/ As the U.S. Court of Appeals for the D.C. Circuit explained in upholding the shift from ROR to price caps for larger ILECs, "because a firm can pass any cost along to ratepayers (unless it is identified as imprudent), its incentive to innovate is less sharp than if it were unregulated." 46/ This conclusion is supported by empirical econometric research, which confirms that

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43/ *AT&T Price Cap Order*, 4 FCC Rcd at 2889-90, ¶¶ 29-31 (emphasis in original).

44/ *Id.*, 4 FCC Rcd at 2890-91, ¶ 34.

45/ *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 8973, ¶ 27 (1995), subsequent history omitted; *ILEC Price Cap Order*, 5 FCC Rcd at 6789-90, ¶¶ 22, 29-32.

46/ *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993).

"using rate-of-return regulation does have the unintended consequence of decreasing the firm's expenditures on R&D." 47/

In the *Universal Service First Report and Order*, the Commission specifically recognized the inefficiency of the current embedded-cost support mechanisms in the context of rural ILECs operating under ROR regulation:

> We find that the current support mechanisms neither ensure that ILECs are operating efficiently nor encourage them to do so. Indeed, by guaranteeing carriers recovery of 100 percent of all loop costs in excess of 150 percent of the national average loop cost, the current high-cost funding mechanisms effectively discourage efficiency. Thus, we agree with [Citizens for a Sound Economy] that calculating high-cost support based on embedded cost is contrary to sound economic policy. We conclude that basing support on forward-looking economic cost or perhaps competitive bidding will require telecommunications to operate efficiently and will facilitate the move to competition in all telecommunications markets. 48/

In addition, the current unjustifiable disparity between the regulatory systems for areas served by so-called "non-rural" ILECs and areas served by rural ILECs creates very strong, uneconomic incentives for large ILECs to sell exchanges to small ones, even though there are economies of scale that can be achieved by the larger carriers. 49/ While sparsely populated rural *areas* undoubtedly are more

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47/ *See, e.g.,* Mark W. Frank, *The Impact of Rate-of-Return Regulation on Technological Innovation* at 124 (Ashgate Publishing Ltd, Aldershot, England and Burlington, VT: 2001).

48/ *Universal Service First Report and Order*, 12 FCC Rcd at 8934-35, ¶ 292 ,. The Commission, however, declined to move rural ILECs into a forward-looking cost-based system immediately due to concerns about the applicability of the cost models to rural ILECs. *Id.* at 8935-37, ¶¶ 293-95.

49/ *See RTF Order*, 16 FCC Rcd at 11310, ¶ 169; *see also* Western Wireless Opposition to Valor Telecommunications of Texas, L.P. Petition for Waiver of Section 54.305, CC Docket No. 96-45 (filed May 30, 2003), at 2-3. There are dozens – possibly hundreds – of cases in which small ILECs have purchased exchanges from larger ILECs and realized economic gains from increased universal service support, with the FCC's sanction. *See, e.g.*, *Nemont Telephone*

costly to serve, there is nothing unique about the rural *ILECs*, and no economically principled reason to provide differing amounts of high-cost support to small ILECs, large ILECs, or competitive ETCs, if the carriers serve similar or identical geographic areas. 50/

C. Embedded Cost-Based Universal Service Support Generates Excessive Funding And Is Highly Susceptible to Fraud, Waste, and Abuse.

Embedded-cost-based support in a system of ROR regulation is arbitrary and not properly reflective of true costs. First, as a theoretical matter, embedded costs are economically irrelevant to economic decision-making, and therefore the use of embedded costs in setting rates and high-cost support is inaccurate. There is a consensus among economists that "it is forward-looking costs, not historical costs, that are relevant in setting prices in competitive markets." 51/ Forward-looking costs – *not* sunk costs – represent the costs that, in the real world, drive the economic decision-making of both incumbent providers and prospective

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Cooperative, Inc., et al., Joint Petition for Waiver of the Definition of "Study Area," 18 FCC Rcd 838, 842-43, ¶ 11 (Wireline Comp. Bur. 2003) (noting that the acquiring companies expect to receive additional interstate common line support as a result of the transfer); *Citizens Utilities Rural Co., Inc. and Qwest Corp., Joint Petition for Waiver of the Definition of "Study Area," Order*, 16 FCC Rcd 13032, 13036, ¶ 10 (Com. Car. Bur. 2001) (permitting Qwest to transfer 38 telephone exchanges to Citizens and noting that "the transferred exchanges may receive increased interstate access universal service support as a result"). *See also* 47 C.F.R. § 54.902..

50/ While there *are* differences between rural areas and other geographic areas – it costs more to serve areas where the population is sparse, whether using wireline or wireless technology, regulation should be neutral on the issue of carrier identity and size, and certainly should not reward a carrier just for being small or for being an incumbent.

51/ *TELRIC NPRM* at ¶ 32.

new entrants regarding investment, production, and pricing. 52/ Thus, a truly "cost-based" system would utilize forward-looking costs, not embedded (or backward-looking) costs.

Second, even if embedded cost-based regulation were appropriate as a theoretical matter, in practice the existing ROR regulatory system is fatally flawed by generations of regulatory distortions. ROR regulation is driven by FCC rules (principally Parts 32, 36, and 69) that were designed for the primary purpose of generating cross-subsidies and/or shifting revenues between the state and federal jurisdictions. 53/ There is no reason to think that the revenues driven by these existing rules have any relationship to the "reality" even as generated by accounting costs.

Third, and perhaps most significantly, the ROR regulatory system is likely to be highly inaccurate because it depends heavily on the ILECs' self-reporting based on their own accounting records, which have never been audited or scrutinized by independent auditors or regulators. As the Commission recently pointed out,

> Traditional rate-base/rate-of-return ratemaking has generally been based on the use of historical costs, *i.e.*, the costs the regulated firm incurred in building its network and providing service and that it

52/ *Id.* at ¶ 30. *See also Local Competition Order*, 11 FCC Rcd at 15813, ¶ 620; Walter Nicholson, *Microeconomic Theory: Basic Principles and Extensions*, pages 279-82 (3rd ed., 1984) (explaining difference between economists' focus on forward-looking costs and accounting focus on sunk costs); Thomas T. Nagle, *The Strategy & Tactics of Pricing: A Guide to Profitable Decision Making*, 14-28 (1987) (at page 15: "Only forward-looking costs are relevant for pricing because only they represent the true cost of doing business.").

53/ *See* Peter W. Huber, Michael K. Kellogg, and John Thorne, *Federal Telecommunications Law* at 551-560 (2d ed. 1999).

> recorded in its books of account. As an initial matter, an historical cost approach is highly dependent on the accuracy of an incumbent LEC's accounting records, which potentially creates a significant information asymmetry that benefits the incumbent LECs. 54/

But no comprehensive audit of the regulatory accounts of the vast majority of rural ILECs has been conducted in the past decade, either by the FCC, state commissions, NECA, 55/ the Universal Service Administrative Co. ("USAC"), or independent auditors retained by the ILECs themselves. Thus, there is no reason to presume the accuracy of the regulatory books of account (kept separately from the books of account maintained and audited for tax purposes).

Indeed, there is good reason to think that the rural ILECs' costs may be significantly overstated, which would result in a bloated high-cost fund. The existing regulatory system provides ample opportunities and incentives for ROR-regulated ILECs to misreport costs in a manner that would improperly augment universal service disbursements and "pad their rates," 56/, such as by improperly allocating costs to ILEC regulated operations that more properly should have been allocated to other activities. As demonstrated in Attachment A to this Petition, certain state commissions have unearthed extensive incidents of cross-subsidization and other improper accounting practices:

54/ *TELRIC NPRM* at ¶ 32.

55/ While NECA does review ROR carriers' cost study and high-cost fund submissions, the scope and outcomes of these reviews are not made public. Moreover, NECA does not have sufficient staff to conduct stringent reviews or audits of all carriers' cost data, and given that NECA (through its Board of Directors) is run by and for the ILECs themselves, NECA is not sufficiently independent of rate of return ILEC interests to support a strong oversight function.

56/ *Price Cap FNPRM*, 3 FCC Rcd at 3219-20, ¶ 39.

- The California Public Utilities Commission found that a mid-sized company had: (i) improperly misallocated corporate/managerial costs, regulatory costs, land and building costs, and other expenses to the ILEC that should have been allocated to the company's cable television, wireless, long-distance, and alarm monitoring affiliates, in violation of the FCC's Part 64 rules; (ii) expensed software development costs in a single year, contrary to Generally Accepted Accounting Principles; and (iii) improperly booked the costs of institutional and goodwill advertising in the ILEC's regulated accounts.

- The Idaho Public Utilities Commission reduced an ILEC's claim to recover the cost of payments to affiliates and certain software capital leases, since those expenditures were related to the provision of unregulated services. The Idaho commission also rejected recovery of the costs of equipment that was no longer in service and costs of fiber that had not yet been placed into service; and it disallowed recovery of corporate image advertising costs and a depreciation reserve deficiency.

- The Kansas Corporation Commission reached a settlement with two RLEC subsidiaries of one holding company that precluded them from receiving any state universal service support, based on a finding that the holding company had improperly allocated the entire cost of management stock incentives and financial advisory fees paid to the owners of the holding company to the regulated ILEC, and had allocated no corporate costs to unregulated subsidiaries.

- The Kansas commission found that another ILEC had claimed depreciation expenses on plant that had already been fully depreciated, misallocated deferred income taxes relating to non-regulated affiliates, and improperly booked consulting fees that had no relationship with regulated operations.

- The Kansas commission found that a carrier had claimed more property tax expense than it had actually paid during the test year, utilized depreciation rates in excess of those permitted by the commission, and improperly included lobbying and corporate image advertising expenses.

- The Oregon commission disallowed an ILEC's claim to depreciation recovery for equipment that had already been retired, rejected recovery of executive bonuses paid for achieving corporate financial goals that benefited shareholders rather than ratepayers, and made adjustments for the company's failure to reflect the reduction in expenses realized through the sale of several exchanges.

- The Vermont commission rejected an ILEC's attempt to recover the non-recurring costs of operational support systems ("OSS"), which had already been recovered through interconnection rates, and of local number portability implementation, for which the FCC had already developed an interstate cost recovery mechanism.

- The Washington commission disallowed an ILEC's recovery of corporate image advertising costs, rejected its attempt to use depreciation rates that the commission had already rejected, and disallowed the costs of purchases from an affiliate at prices that exceeded market prices.

Other examples are discussed in Attachments A and B.

Given the very strong perverse incentives and the lack of effective auditing or oversight of their ROR accounting, undoubtedly a far greater number of incidents are never detected, resulting in excess support flowing to the ILECs. The Commission cannot ignore the ROR ILECs' interstate overearnings (*i.e.*, revenues from interstate access charges plus universal service fund disbursements that exceed the 11.25% allowed rate-of-return) of over $218 million in the 2001-2002 period, $92 million in 1999-2000 and $121 million in 1997-1998. 57/

Moreover, even if and when the Commission does detect ROR carriers' over-earnings, the Commission may not be able to remedy them. In a recent case, the Commission found that an ILEC had earned excessive amounts by improperly allocating certain costs to the interstate jurisdiction that applicable rules required to be treated as intrastate. The reviewing court upheld the Commission's

57/ *See* AT&T Ex Parte Filing, CC Docket Nos. 00-256, 96-45, 98-77, and 98-166 (filed May 9, 2003) (demonstrating that numerous rate-of-return ILECs are earning in excess of the 11.25% authorized rate of return).

conclusion that the ILEC had misallocated these costs. 58/ Nonetheless, the court held that, because the Commission had not suspended the tariff rates and established an investigation at the time the relevant tariff was filed, the rates were conclusively "deemed lawful" under 47 U.S.C. § 204(a)(3), and therefore the Commission was without authority to order rate refunds or damages. 59/ Thus, even with respect to those incidents of ROR malfeasance that the Commission detects (most likely a small minority), in most cases the Commission may lack authority to order an effective remedy. In effect, this could well mean that ROR regulation is unenforceable in the context of tariffed interstate access charges. An alternative regulatory framework is urgently needed.

"In an era of corporate governance problems and accounting depredations, this Commission has an especially high burden" of responsibility to establish and enforce accounting safeguards "that help prevent and detect anticompetitive behavior" by rural ILECs. 60/ The most effective way to preclude such waste, fraud, and abuse would be to eliminate the ROR regulatory system, which provides the opportunity and incentives for such misconduct. However, during the time period when ROR regulation remains in effect, we propose a

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58/ *ACS of Anchorage, Inc. v. FCC*, 290 F.3d 403 (D.C. Cir. 2002), *affirming in part and reversing and remanding in part General Communication, Inc. v. Alaska Communications Systems Holdings, Inc.*, 16 FCC Rcd 2834 (2001).

59/ *Id.*

60/ Separate Joint Statement of Commissioner Michael J. Copps and Commissioner Jonathan S. Adelstein, Concurring, *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, Further Notice of Proposed Rulemaking, FCC 03-111 (released May 19, 2003).

number of interim steps that the Commission should take to oversee the ROR regulatory process more stringently, enhance the transparency of the process, and limit the potential for abuse. Specifically, the FCC should make the following changes immediately:

- Carriers' cost studies, work papers, and other data submissions supporting their high-cost funding should be made publicly available, given that high-cost support is a form of public funding.

- As with the 1999 audits of the Bell companies' Continuing Property Records, 61/ the results of any reviews of cost studies or other data submissions involving high-cost funding conducted by the NECA or USAC over the past three years should be made publicly available.

- Truly independent auditors (*i.e.*, public accounting firms) should be retained under the supervision of the Commission and/or USAC to conduct audits of the data underlying the high-cost submissions of ROR ILECs no less frequently than every three years, and more frequently if there is a significant increase in a company's year over year funding requests. Companies should be required to provide full access to their books and records, and the results of the audits would be made publicly available.

- Among other matters, audits should focus on whether the subject ILEC is properly classifying its loops and other facilities in reporting loop counts and network investments; whether the carrier has proper cost accounting manuals, with adequate internal controls in place; whether the carrier complies with affiliate transactions rules; and whether costs are booked to the correct Part 32 accounts, and other factors such as interest expense on debt and interest during construction, and cash working capital are recorded and accounted for correctly. 62/

61/ *Ameritech Corporation Tel. Op. Cos. Continuing Property Records Audit*, 14 FCC Rcd 4273 (1999); *BellSouth Tel. Continuing Property Records Audit*, 14 FCC Rcd 4258 (1999); *Bell Atlantic (South) Tel. Cos. Continuing Property Records Audit*, 14 FCC Rcd 5541 (1999); *Bell Atlantic (North) Tel. Cos. Continuing Property Records Audit*, Order, ASD File No. 99-22 (Mar. 12, 1999); *Pacific Bell and Nevada Bell Tel. Cos. Continuing Property Records Audit*, 14 FCC Rcd 5839 (1999); *U S West Tel. Op. Cos. Continuing Property Record Audits*, Order, ASD File No. 99-22 (Mar. 12, 1999); *Southwestern Bell Tel. Co. Continuing Property Records Audit*, 14 FCC Rcd 4242 (1999). (collectively, "*RBOC Audit Orders*") (subsequent history omitted).

62/ *See* Attachment B, at 10-11.

- The Commission should immediately suspend and investigate *all* tariff filings of ROR carriers in order to avoid the statutory "conclusive presumption" that the rates are "deemed lawful," and thereby preserve the Commission's ability to order refunds or damages in the event that over-earnings are later detected.

* * * * *

In sum, the current system of embedded cost-based support for rural ILECs and ROR regulation artificially inhibits the development of competition, encourages inefficiencies, and creates opportunities for ILECs to improperly expand the size of their funds through fraud, waste, and abuse. Rather than making regulatory changes that would impose further artificial constraints on competition, such as eliminating portability, it is time to eliminate embedded cost-based support and ROR regulation.

IV. THE COMMISSION SHOULD ESTABLISH A COMPETITIVELY NEUTRAL, PORTABLE HIGH-COST FUNDING SYSTEM BASED ON FORWARD-LOOKING COSTS

The Commission should open a proceeding to develop a more appropriate high-cost funding system based on forward-looking costs to determine identical support amounts for all ETCs serving a particular geographic area. As the Commission recently explained:

> A forward-looking costing methodology considers what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network. The benefit of a forward-looking approach is that it gives potential competitors efficient price signals in deciding whether to invest in their own facilities or to lease the incumbent's facilities. That is, if construction of new facilities by a competitive LEC would cost less than leasing facilities at prices based

> on [forward-looking economic cost], the efficient result is for the new entrant to build its own facilities. 63/

Forward-looking costs – determined using an economic model or other forward-looking methodology, rather than by reference to an individual carrier's accounting records – more accurately gauges the costs driving economic decision-making by any enterprise. Forward-looking costs can also be neutral as between incumbents and new entrants, and between wireless and wireline technologies:

> [W]e find that the use of mechanisms incorporating forward-looking economic cost principles would promote competition in rural study areas by providing more accurate investment signals to potential competitors. * * * Because support will be calculated and then distributed in predictable and consistent amounts, such a forward-looking economic cost methodology would compel carriers to be more disciplined in planning their investment decisions.. 64/

A. The Commission Should Develop Appropriate Forward-Looking Costing Analytical Platforms and Inputs

The first step in developing a new forward-looking cost-based system for computing high-cost support is developing an analytical platform and appropriate inputs with respect to the forward-looking cost – "what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network" 65/ – in areas served by rural ILECs and their competitors. The Commission should seek comment on issues such as the following:

63/ *TELRIC NPRM* at ¶ 30.

64/ *Universal Service First Report and Order,* 12 FCC Rcd at 8935-36, ¶ 293.

65/ *TELRIC NPRM* at ¶ 30.

- Whether the existing Synthesis Model provides an adequate model platform for this purpose;
- If so, what modifications to input assumptions (if any) would be needed to apply that model to areas served by rural ILECs and their competitors;
- If the Synthesis Model cannot be used or adapted, how an alternative model platform or other forward-looking cost methodology should be developed. 66/

Although, the Rural Task Force expressed reservations about utilizing the existing Synthesis Model to develop support amounts for rural carriers, 67/ the Commission correctly recognized that:

> Many commenters representing the interests of rural telephone companies argue that the Rural Task Force's analysis conclusively demonstrates that the forward-looking cost mechanism should not be used to determine rural company support and that only an embedded cost mechanism will provide sufficient support for rural carriers. *We disagree*. While the Rural Task Force demonstrated the inappropriateness of using input values designed for non-rural carriers to determine support for rural carriers, we do not find that its analysis justifies a reversal of the Commission's position with respect to the use of forward-looking cost as a general matter. 68/

It is also significant that the recent *TELRIC NPRM* seeks comment on forward-looking costing matters with respect to UNEs offered by small ILECs as well as larger carriers. 69/ While UNE pricing entails some different methodological issues

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66/ Western Wireless has demonstrated that it is quite possible to develop an appropriate model to implement a forward-looking cost methodology for rural ILECs. *See* James W. Stegeman, "Proposal for a Competitive and Efficient Universal Service High-cost Funding Model/Platform," Attachment I to Western Wireless Comments in *Joint Board Competitive ETC Proceeding*.

67/ *Rural Task Force Recommendation to the Federal-State Joint Board on Universal Service*, 16 FCC Rcd 6165, 6181 (2000).

68/ *RTF Order*, 16 FCC Rcd at 11311-12, ¶¶ 174-75 (emphasis added)(citations omitted).

69/ *TELRIC NPRM* at ¶¶ 161, 163.

than determination of forward-looking costs for universal service high-cost support purposes, there are many related issues, and the Commission can productively address both the UNE pricing and high-cost support issues simultaneously, and can do so using many (if not all) of the same criteria. For example, for purposes of developing appropriate forward-looking inputs to the rural universal service cost methodology, the Commission should consider how to develop dynamically efficient, forward-looking demand estimates that account for the development of facilities-based competition (*i.e.*, that no single provider's facilities will serve 100% of the consumer demand in any given area). 70/

The Commission's costing analysis efforts in the context of universal service should not be limited to ILEC network costs. In many cases, wireless networks may incur lower forward-looking costs to provide basic universal service. 71/ For example, in 1998 Western Wireless developed a Wireless Cost Model based largely on the HAI wireline model, but incorporating a wireless network module in place of the HAI model's standard wireline loop module. The Hatfield Wireless Model ("HWM") estimates the cost of wireless service, using cluster population data and ILEC traffic loads to determine cell site, equipment,

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70/ *Cf. TELRIC NPRM* at ¶ 75.

71/ For this purpose, both ILEC and CMRS cost models should estimate the cost of providing the supported services included in the "definition of universal service." *See Federal-State Joint Board on Universal Service*, Order and Order on Reconsideration, 18 FCC Rcd 15090 (2003) (reaffirming existing definition of "universal service").

and backhaul requirements, and using the transport, switching, signalling and other cost data from the HAI wireline model. 72/

The goal of universal service must be to preserve and advance universal service as efficiently as possible, and therefore the forward-looking approach for purposes of determining high-cost support amounts should be calculated, for *all* carriers, based on the *lesser* of the forward-looking cost of ILEC network technology or the forward-looking cost of wireless network technology. The Commission recently reaffirmed its "commitment to forward-looking costing principles," and explained that "[a] forward-looking costing methodology considers what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network. 73/ Consistent with the Commission's theory of forward-looking cost, the Commission should make funding available based on the *lower* of the efficient forward-looking costs of ILEC real-world networks and the efficient forward-looking costs of real-world wireless networks, developed based on "the real-world attributes of the routing and topography" of such carriers' networks. 74/ For example, Western Wireless demonstrated that, if universal service support were based on the lesser of ILEC forward-looking costs or wireless forward-looking costs, then there

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72/ *See Ex Parte* Letter from David L. Sieradzki, Counsel for Western Wireless Corp., to Magalie Roman Salas, FCC Secretary, CC Docket No. 96-45 (Aug. 26, 1998) (available at http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=2140160001 and http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=2140160002) ("*Western Wireless Model Ex Parte*").

73/ *TELRIC NPRM,* ¶¶ 29, 30.

74/ *Id.* at ¶ 52.

could be a savings of 48% compared to providing universal service support based only on wireline technology. 75/

As part of the process of re-examining the forward-looking cost analytical process, the Commission should reconsider some of the ILEC-centered assumptions it has made in its past modeling efforts. For example, in the original Synthesis Model for high-cost universal service support, the Commission began with an assumption that the basic geographic unit of analysis was the ILEC wire center. The Commission should consider dropping that assumption and, instead, use a technology-neutral geographic unit of analysis, such as counties or census-block-groups. One advantage of such an approach is that data on the specific geographic boundaries and other features of such units are more readily available to the public than ILEC wire center and study area boundaries.

B. The Commission Should Establish a Competitively Neutral Methodology to Derive Support Amounts

Once the Commission has an analytical methodology in place to determine forward-looking costs for each specified geographic area, the next step is to establish the rules for deriving support amounts. Western Wireless submits that such rules should meet each of the following criteria:

(1) As directed by the Tenth Circuit, the methodology for all carriers, rural as well as non-rural, must be "sufficient" and must be targeted to advance the statutory goals of "affordable" rates in high-

75/ *Western Wireless Model Ex Parte*, Attachment 2 ("Universal Service: The Wireless Solution"), at 19.

cost areas that are "reasonably comparable" to those in urban areas. 76/

(2) The methodology must be competitively and technologically neutral. Thus, it should not make any difference whether the geographic area is served by a rural ILEC, a non-rural ILEC, a competitive ETC, or some combination.

(3) The methodology should provide sufficient federal support for a carrier seeking to serve a given high-cost geographic area, regardless whether that area is located in a state with average costs that are above or below the national average.

(4) The methodology should provide sufficient *federal* support to give states with costs well above the national average the resources to supply any needed intrastate support.

(5) The methodology should include "inducements" for states to take any necessary intrastate actions to eliminate implicit support, as required by the 1996 Act. 77/

There are a number of possible approaches that would satisfy these objectives. Qwest Communications outlined one possible approach in its comments

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76/ *Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001). *See also Tenth Circuit Remand Order*, ¶¶ 36-48 (clarifying FCC's definitions of key terms).

77/ *Qwest Corp. v. FCC, supra.*

in the Tenth Circuit Remand proceeding. 78/ Under Qwest's proposal, the current high-cost support mechanisms (model-based support and Interstate Access Support) would be replaced by what Qwest called "Tier One" and "Tier Two" support. Tier One Support would be based on a simple comparison of the cost of service in each area with a national benchmark (such as the $31 benchmark currently used in determining support for non-rural carriers). Tier Two Support (like the Model-Based Fund today) would be designed to provide funding to the highest-cost states that have the least ability to generate needed intrastate funding based on the divergence between the statewide average cost and the national average, while at the same time ensuring that the most rural areas are eligible for federal universal service funding. While Qwest offered its proposal specifically for areas served by non-rural ILECs and their competitors, Western Wireless believes a similar approach could also be applied to areas served by rural ILECs and their competitors. The Commission should seek further comment on this idea. 79/

78/ Qwest Comments, CC Docket No. 96-45 (10th Circuit Remand Proceeding) (filed April 10, 2002); *see also Ex Parte* Letter from John W. Kure, Qwest, to Marlene H. Dortch, Secretary, CC Docket No. 96-45 (filed Oct. 1, 2003) (summarizing Qwest's position on the Tenth Circuit remand).

79/ While the Commission did not adopt Qwest's proposal in the *Tenth Circuit Remand Order,* it did not altogether reject it either – the further NPRM mentions the proposal and seeks further comment on related issues. *See Tenth Circuit Remand Order FNPRM,* ¶ 130 n.420.

Another, similar alternative would be to provide increasing percentages of federal support for geographic locations of increasing cost. For example, the federal fund could provide 25% of the difference between the forward-looking cost and the benchmark average cost for locations with costs that are 135% to 150% of the national average; 50% for locations 150% to 200% of the average; 75% for locations 200% to 250% of the average; and 100% of the difference between the forward-looking cost and the benchmark average cost for locations with costs that are 250% of the national average.

C. The Rules Must Include Inducements for Eliminating Implicit Subsidies from Retail Rates

Section 254 forbids the Commission from indefinitely maintaining implicit subsidies in the interstate rate structure, 80/ and at a minimum "states a clear preference" that states take complementary actions to eliminate implicit support from intrastate rates. 81/ This is because, as the Commission has long recognized, "implicit subsidies . . . have a disruptive effect on competition;" 82/ "may discourage efficient local and long distance competition in rural areas and limit consumer choice;" 83/ and "may undermine efficient competition by permitting an incumbent carrier to price services below cost." 84/ Western Wireless submits that, consistent with the Tenth Circuit's ruling, the universal service high-cost support

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80/ *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 406 (5th Cir. 1999); *Alenco*, 201 F.3d at 624; *Texas Office of Public Utility Counsel v. FCC*, 265 F.3d 313, 318 (5th Cir. 2001).

81/ *Tenth Circuit Remand Order,* ¶ 26; *see also Qwest Corp. v. FCC*, 258 F.3d at 1203; *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 395, 393-94 (1999) (noting that "§ 254 requires that [intrastate] universal service subsidies be phased out, so whatever possibility of arbitrage remains will be only temporary" in response to ILEC concerns that availability of unbundled network elements at TELRIC would enable entrants to avoid the burden of universal service subsidies built into ILECs' intrastate retail rates).

82/ *Access Charge Reform*, Order on Remand, 18 FCC Rcd 14976, 14977-78, ¶ 2 (2003).

83/ *MAG Order*, 16 FCC Rcd at 6-7, ¶ 6.

84/ *Id.*, n.193. *See also Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, 15995-96, ¶ 30 (1997) ("Implicit subsidies also have a disruptive effect on competition, impeding the efficient development of competition in both the local and long-distance markets. For example, where rates are significantly above cost, consumers may choose to bypass the incumbent LEC's switched access network, even if the LEC is the most efficient provider. Conversely, where rates are subsidized (as in the case of consumers in high-cost areas), rates will be set too low and an otherwise efficient provider would have no incentive to enter the market. In either case, the total cost of telecommunications services will not be as low as it would otherwise be in a competitive market. Because of the growing importance of the telecommunications industry to the economy as a whole, this inefficient system of access charges retards job creation and economic growth in the nation.").

structure for areas served by rural ILECs, as well as for non-rural ILECs, should include inducements for the ILECs and their state regulators to eliminate implicit support from their rate structures. By adopting a structure such as Qwest's two-tier proposal, the Commission would ensure that every state receives a reasonable amount of support, and the threat of depriving the state and its carriers of that support would establish an inducement to eliminate implicit subsidies.

Western Wireless submits that the Commission should limit ILEC high-cost support unless their basic retail rates for residential universal service recover at least a minimal amount of revenue corresponding to an "affordable" rate under the statute. 85/ Rural ILECs typically recover 50% to 75% of their revenues from universal service funding and access charges, not from their own customers; and a significant number of those carriers maintain unreasonably low retail rates. 86/ Not only does this unhealthy dependence on high-cost support and access charges insulate these carriers from any incentive to be responsive to their own consumers' needs. It also means that, in cases where retail rates are extraordinarily

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85/ This proposal is different from, and distinguishable from, SBC's proposal regarding an "affordability benchmark" for each geographic area, which the Commission rejected in the *Tenth Circuit Remand Order,* ¶ 45. SBC proposed setting high-cost support based on the difference, in each geographic area, between the forward-looking cost of service and an affordability benchmark determined based on a percentage of average household expenditure levels. *See* SBC Comments, CC Docket No. 96-45, at 15-16 (filed Dec. 20, 2002). By contrast, Western Wireless' proposal here would simply preclude the disbursement of federal support to carriers that recover unreasonably low rates, below minimal "affordable" levels, from their end-users, in order to protect consumers across the country from providing unreasonable subsidies to such carriers. The Commission should seek comment on specific implementation issues related to this proposal, such as the definition of "affordable" rate levels in each geographic area.

86/ *See, e.g.*, Fred Williamson & Assocs., Inc., Comments, CC Docket No. 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 11-12 (certain rural ILECs in Kansas receive only 17% of their revenue per access line from their end-user customers, and the remainder from interstate and intrastate access charges and universal service funds).

low, consumers around the country, who pay into the high-cost fund, are being forced to provide unfairly generous subsidies.

To be sure, rural consumers are entitled under the Act to rates that are "affordable" and "comparable" to rates available elsewhere, with the support of the federal high-cost universal service program. But they are not entitled to subsidized rates *below* affordable and comparable levels. Such unreasonably low retail rates, maintained through regulatory policies, also pose a barrier to competitive entry.

Accordingly, Western Wireless submits that, in order to create inducements to eliminate implicit subsidies, the level of federal universal service support available to a carrier would be based upon whether a carrier's retail rates are at or above an "affordability" benchmark. 87/ Carriers whose basic retail rates are below that benchmark would be limited in the amount of support they are eligible to receive.

V. THE COMMISSION SHOULD ESTABLISH RULES THAT GRADUALLY PHASE IN THE NEW FORWARD-LOOKING COST-BASED SYSTEM AND PROVIDE FOR A REASONABLE TRANSITION

Western Wireless recognizes that it is proposing a significant transformation in the high-cost universal service system and in the way rural ILECs are regulated. Accordingly, Western Wireless believes that a gradual transition plan is appropriate, as follows.

87/ *See, e.g.,* Sprint Comments, CC Docket No. 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 15-19.

First, the new rules should not become effective until 2006, upon the expiration of the five-year period provided by the *RTF Order*, and should apply initially only to competitive ETCs, non-rural ILECs, and rural ILECs owned by relatively large holding companies. The rules should be phased in more gradually for smaller rural ILECs. Second, a transitional mechanism should be established such that no carrier's high-cost support is reduced by more than 20% in any one funding year. Third, a "safety net" should be available under which a carrier could show, using clear criteria established in advance, that it needs additional support to avoid hardship.

In the *RTF Order*, the Commission determined that the key elements of that plan would remain in place for a five-year stability period, running through mid-2006. 88/ Similarly, in the *MAG Order*, the Commission concluded that the key features of the access charge reform plan adopted in that order should remain in place for the same five-year period. 89/ Western Wireless believes that the Joint Board and the Commission must keep their promises and deliver the regulatory stability that they promised to ILECs and competitive ETCs alike, which is crucial for investment and economic decision-making. However, it is certainly timely for the Commission to begin now to lay the groundwork necessary to begin eliminating

88/ *RTF Order*, 16 FCC Rcd at 11309-10, ¶ 167.

89/ *MAG Order*, 16 FCC Rcd at 10, ¶ 15.

rate-of-return regulation as of the end of the 5-year RTF stability period, as was presaged in the *RTF Order*. 90/

Western Wireless proposes that the new system of high-cost universal service funding and interstate access charge regulation be introduced in 2006, at the end of the five-year period of the RTF plan, and phased in gradually thereafter. Specifically, in 2006, the new universal service system should apply only to competitive ETCs; non-rural ILECs; and rural ILEC study areas with 100,000 or more lines in all affiliated study areas nationwide and/or 30,000 lines or more in all affiliated study areas statewide. The plan would be extended in 2008 to rural ILEC study areas with 50,000 or more lines in all affiliated study areas nationwide and/or 15,000 or more lines in all affiliated study areas statewide; and in 2010 to rural ILEC study areas with 20,000 or more lines in all affiliated study areas nationwide and/or 5,000 or more lines in all affiliated study areas statewide. The plan would not be applied to the smallest rural ILECs until 2012.

In order to prevent "rate shock" to carriers whose support payments are reduced, Western Wireless suggests that, in addition to the gradual implementation schedule proposed above, the plan be implemented in such a way that no ILEC study area loses more than a specified percentage (20 or 25 percent) of the amount of support it previously received in any one year. "Hold-harmless" support should be made available, in addition to the forward-looking cost-based support, to ease the transition process. Competitive ETCs operating in such a study

90/ *See RTF Order,* 16 FCC Rcd at ¶ 12.

area would receive a comparable amount of portable support (on a per-line basis) for each customer connection they serve.

Furthermore, as in the RTF plan, Western Wireless believes that a "safety net" supplementary support mechanism should be available. If a carrier can prove that, in its particular circumstances, the amount of support is not sufficient to provide the basic universal services, an additional safety net or supplemental mechanism should be available for a limited period of time. Specific criteria for such supplemental support would have to be adopted in advance. This would prevent rate shock and unduly rapid transitions for the RLECs, while ensuring an orderly change to the system based on forward-looking costs.

VI. THE COMMISSION SHOULD FURTHER REFORM RLEC INTERSTATE ACCESS CHARGES TO FULLY ELIMINATE IMPLICIT SUBSIDIES

As part of its elimination of ROR regulation of the RLECs, the Commission should seek comment on changes to the interstate access charge rules. Specifically, the Commission should consider *rate structure* rule changes needed to rebalance the rates charged by ROR carriers and eliminate all implicit subsidies embedded in those carriers' interstate access charges. 91/ The Commission should

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91/ *See Tenth Circuit Remand Order FNPRM*, ¶ 127 (encouraging states "to replace implicit support with explicit support mechanisms that will be sustainable in a competitive environment"). Consistently, the Minnesota Public Utilities Commission recently commenced an inquiry into rebalancing of local rates and intrastate access charges, and related universal service rule changes, in order to eliminate implicit "subsidies that may inhibit the development of viable competition and the benefits it may yield in the form of consumer choice, service quality, efficiency, and as an impetus to technological advance. Competitors cannot profitably enter local markets where they bear operation costs higher than the subsidized rates they must meet in order to compete." Statement of Proposed Inquiry, *Commission Investigation of Intrastate Access Charge Reform*, Docket No. P-999/CI-98-674; *Universal Service Rulemaking*,

also modify its policies regarding access charge *rate levels* of ILECs currently subject to ROR regulation. These policy changes should be coordinated with the Commission's broader efforts to reform and harmonize the rules governing inter-carrier compensation.

First, the Commission should significantly increase or eliminate altogether the caps on subscriber line charges ("SLCs"), which preclude ILECs from recovering the full cost of loops from end-users. The Commission has long recognized that ILECs incur loop costs on a non-traffic sensitive basis; that the most economically efficient way to recover those costs is on a non-traffic sensitive basis from the cost-causers (end-users); and that SLC caps constitute an implicit subsidy from access customers (and universal service contributors who pay into the ICLS fund) to end users. The Commission should put an end to such implicit subsidies. This does not necessarily have to lead to an increase in the rates charged to end-users. However, rather than relying heavily on implicit subsidy mechanisms such as SLC caps to ensure that end-user rates are reasonable and affordable, the Commission should instead use forward-looking cost-based universal service support to achieve reasonable end-user rates – but only to the extent needed, and only on a competitively-neutral basis.

Second, the Commission should seek comment on other rate structure changes to eliminate implicit subsidies from the interstate access rate structure,

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Docket No. P-999/R-97-309; *Commission Investigation of Cost for the Appropriate Level of Universal Service Support*, Docket No. P-999/CI-00-829, at p.2 (issued Oct. 13, 2003) (available at http://www.puc.state.mn.us/docs/stmtofinq.pdf).

such as the rule that local switching costs be recovered from long-distance carriers on a traffic-sensitive basis. The Commission has recognized that ILECs incur the cost of the "port" component of local switching on a non-traffic sensitive basis, and many parties have argued that the remainder of local switching costs are largely, or possibly entirely, non-traffic sensitive. 92/ If these arguments are correct, then some or all of the local switching charges currently paid by long-distance carriers on a traffic-sensitive basis ought to be paid by end-users on a non-traffic sensitive basis.

Third, the Commission should modify its rules to set ILECs' access charge rate levels – *i.e.*, the SLCs and switching charges paid by end-users, as well as the local transport and any possible remaining local switching charges paid by long-distance carriers – based on forward-looking costs, rather than embedded costs. As the Commission has made clear in recent access charge proceedings, it is possible to assess the reasonableness of access rates based on forward-looking costs. 93/ Moreover, the Supreme Court has affirmed that forward-looking economic cost-based rates can be fully compensatory to the ILECs. 94/ Such reform is overdue and should be adopted with respect to all ILEC interstate access charges.

Fourth, with respect to future adjustments in access rate levels, the Commission should consider whether the existing price cap system that applies to

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92/ *See, e.g.*, AT&T Comments, CC Docket No. 02-148, filed July 3, 2002, at 66-69.

93/ *Cost Review Proceeding for Residential and Single-Line Business Subscriber Line Charge (SLC) Caps*, Order, 17 FCC Rcd 10868 (2002) (evaluating the forward-looking costs of price cap ILECs' loops, and concluding that a substantial proportion have costs in excess of the $6.50 SLC cap).

94/ *Verizon v. FCC,* 535 US at 471.

non-rural ILECs should be applied to the RLECs, or whether modifications to that system might be appropriate. Moreover, the Commission should consider whether to adopt pricing flexibility rules comparable to, or different from, the measures that apply to the larger ILECs. In particular, it might be appropriate to use the receipt of high-cost support by a competitive ETC as a "trigger" for certain types of pricing flexibility for the RLECs.

Finally, access charge issues should be addressed in the context of the pending *Intercarrier Compensation* proceeding. Western Wireless supports the Commission's objective of ultimately reducing all forms of intercarrier compensation to zero, and requiring all carriers to recover revenues from their own customers rather than from other carriers. Eliminating ROR regulation of the RLECs should facilitate the Commission's accomplishment of its goals in this regard. In particular, reduction of the excessive access charges collected by the RLECs will eliminate a competitive inequality from the rural marketplace, in that ILECs are entitled to impose tariffed access charges on long-distance carriers, but CMRS carriers are prohibited from doing so. Reduction of RLEC access charges will also lead to economic efficiency and should benefit rural consumers, who currently suffer from a severely distorted long-distance and local marketplace.

VII. CONCLUSION

For the foregoing reasons, the Commission should take expeditious action to phase out rate-of-return regulation as the basis for small and mid-size ILECs' universal service disbursements and access charges. This would serve the

public interest far more efficiently –and would control the growth of the fund much more effectively – than some of the anti-competitive proposals that the ILECs have advocated in the *Joint Board Portability Proceeding*. Instead of the antiquated, inefficient, and anti-competitive system of ROR regulation, the Commission should develop a regulatory system based on forward-looking cost.

Respectfully submitted,

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October 30, 2003

Rate of Return Regulation:
Problems That Can No Longer Be Ignored

ATTACHMENT A

to

Western Wireless Corporation's

Petition For Rulemaking To
Eliminate Rate-Of-Return Regulation
Of Incumbent Local Exchange Carriers

October 30, 2003

Rate of Return Regulation:
Problems That Can No Longer Be Ignored

Rate of Return Regulation: A Failed Model of Economic Regulation

Western Wireless Corporation ("Western Wireless") addresses the theoretical and practical problems that result from using an embedded cost/rate of return methodology to determine universal service funding for smaller incumbent local exchange carriers ("ILECs") in a separate paper, "Rate of Return Regulation: A Failed Model of Economic Regulation," released on June 3, 2003.[1] Western Wireless showed that carriers have both the incentive and ability to manipulate their embedded cost study results to maximize their universal service fund ("USF") and/or interstate access revenue and documented instances in which the Federal Communications Commission ("FCC") has found that carriers have done so. Western Wireless recommended that rate of return regulation for smaller ILECs be replaced by a system in which USF payments to all ILECs are based on forward looking economic costs ("FLEC"). Until such time as an appropriate FLEC model can be developed for smaller ILECs, Western also recommended that the FCC establish a stringent and comprehensive audit program over ILEC embedded cost studies to ensure the integrity of the high cost fund mechanisms.

In this Paper, Western Wireless further documents instances in which ILECs have manipulated their embedded cost studies to maximize their USF and/or access revenue. This time, Western Wireless focused its review on state commission proceedings in which large or small ILEC embedded cost studies were thoroughly scrutinized. State commissions typically conduct more comprehensive audits or reviews of carriers' cost

studies than does NECA or the Commission, which, in itself, is a problem and raises the issue of lack of federal oversight of ILEC cost studies. It is highly likely that, if conducted by NECA or the FCC, thorough audits of ILECs' USF and access cost studies would reveal problems similar to those identified by the states herein (the problems with the ILECs' federal cost studies would likely be of even greater magnitude given the historic lack of oversight).

The cost studies reviewed for this Paper were submitted in different types of proceedings: rate cases, earnings investigations, state universal fund audits, and earnings sharing calculations under alternative regulatory mechanisms. The lack of oversight of ILEC cost studies is also a problem at the state level because detailed reviews of carrier cost submissions have become less common in the last few years -- most states no longer regulate the former Bell Operating Companies ("BOCs") on a rate of return basis and many states either no longer or do not actively regulate the local rates of smaller ILECs and/ or cooperatives.

The results of Western Wireless' review of state commission proceedings involving ILEC cost studies are striking. In virtually all instances, significant problems with the carriers' cost submissions were identified that resulted in disallowances of specific cost items and/or a settlement with the carrier receiving significantly less than originally requested. The abuses uncovered included misstated affiliate transactions, failure to fully and accurately identify and allocate nonregulated costs, inclusion of costs that were not related to the provision of regulated services, and accounting misclassifications.

Kansas Case Study

In 1998, the Kansas Corporation Commission ("KCC") began a series of audits and general rate investigations of ILECs that received Kansas Universal Fund Support ("KUSF") to ensure that the level of support received by each carrier was based on its costs and that its rates were just and reasonable. Many of these proceedings resulted in stipulated settlements with no detailed findings and conclusions, but simply a settlement that required the company to reduce its draw from the KUSF to eliminate excess intrastate earnings.

JBN Telephone Company: The telephone company claimed a revenue deficiency of $572,917, but after KCC scrutiny of its costs, JBN entered into a settlement agreement that required it to reduce intrastate revenues by $690,000 annually by reducing its draw form the KUSF.[2]

Wilson Telephone Company: The telephone company claimed a revenue deficiency of $142,459, but reached a settlement with the KCC that required it to reduce intrastate revenues by $148,000.[3]

Craw-Kan Telephone Cooperative: The telephone company claimed a revenue deficiency of approximately $300,000, but agreed to reduce its intrastate revenues by $500,000 in a settlement with the KCC.[4]

Bluestem and Sunflower Telephone Companies: Bluestem and Sunflower are subsidiaries of Fairpoint Communications, a mid-sized holding company.[5] One of the principal areas of contention was the management services agreement between the telephone companies and the holding company/service corporation. The management services agreement governed the allocation of costs charged to the telephone companies for corporate and

management services. The findings of the KCC are revealing of the types of issues and problems that can be uncovered by a careful investigation of telephone company costs, including:[6]

- Financial advisory fees paid to Fairpoint's investor/owners for advice on equity financing and strategic planning of $1 million were allocated to the telephone companies. These were deemed not related to the provision of regulated services.

- The cost of stock based compensation ($12.3 million), essentially stock dividends, was allocated to the telephone companies. The staff found that "Rate Base rate of return regulation does not recognize dividends as part of the revenue requirement determination; therefore, the inclusion of this charge effectively provides a return to the corporate parent and a return or profit above the authorized return, to the investor."[7]

- Some nonregulated subsidiaries (e.g., Fairpoint Solutions) appeared to receive no allocation of corporate costs and some of the proposed allocation factors effectively resulted in no costs being allocated to many nonregulated subsidiaries. Some subsidiaries had zero or negative cost allocations.

- Historically, management fee allocations were based on revenues, which do not necessarily reflect cost causation.

- It was left to the General Manager's discretion to determine which accounts should be charged the management fees, potentially compromising the integrity of the companies' accounts.

The KSS staff's recommendation was that only $10.6 million of Fairpoint's corporate costs should be allocated to its operating companies, compared to the $34.2 million Fairpoint had allocated for its 2000 test year. Under the settlement agreement reached with Bluestem and Sunflower, the telephone companies were required to reduce their draw from the KUSF to zero.

Southern Kansas Telephone Company: In its review of Southern Kansas' cost studies, the KCC uncovered other ingenious attempts a misallocation of costs, including:[8]

- Southern Kansas claimed deferred income tax asset included the effects of tax timing differences related to nonregulated expenses.

- Southern Kansas claimed depreciation expense on plant that had been fully depreciated.

- Southern Kansas failed to reflect a known and measurable increase in federal USF for the period when KUSF would be paid and rates would be in effect.

- Payments to a consulting group that focuses on family relationships and the dynamics of families working together had not been shown to benefit regulated ratepayers.

In the end, the KCC found that Southern Kansas had over earnings in excess of $2,828,214.

Rural Telephone Company: The KCC found the following transgressions on the part of Rural Telephone Company:[9]

- Claimed more property tax expense than it had actually paid during the test year.

- Calculated its depreciation expense on its largest outside plant accounts using depreciation rates in excess of those permitted by the KCC.

- Included lobbying and corporate image advertising expenses, costs that benefit the company, not the regulated ratepayer.

As a result of these, and other adjustments, the KCC found that Rural had excess intrastate revenues of $801,533.

California Case Study

The California Public Utilities Commission's (CPUC) Office of Ratepayer Advocates (ORA) conducted an extensive audit of the affiliate and nonregulated transactions of Roseville Telephone Company ("RTC") and uncovered the following improper allocations of costs:[10]

- RTC's CEO, CFO and their staffs had allocated only 8 out of 31,000 hours to affiliate and nonregulated operations.
- RTC's VP of marketing had done some work for Roseville Cable, but the costs were not properly assigned to Roseville Cable.
- RTC failed to assign any accounting, budget and finance development costs and the revenue accounting manager's time to Roseville Long Distance.
- RTC had allocated its information services costs based on out of date and incorrectly developed end user service order, payment and collection factors that underallocated RTC's computer infrastructure costs to affiliates and unregulated operations.
- The cost of a valuation study related to the transfer of RTC's wireless interests to an unregulated affiliate were charged to RTC.
- RTC failed to bill Roseville Cable for regulatory costs incurred for Roseville Cable.
- Alarm Monitoring costs were inappropriately booked in RTC's regulated accounts.
- Employee health insurance costs for an unregulated affiliate were paid by RTC.
- RTC had booked the costs of institutional and goodwill advertising in its regulated accounts, in direct contravention of CPUC policies.
- RTC failed to bill a substantial portion of the costs to establish its long distance affiliate to that affiliate.
- RTC charged its wireless affiliate a market rate for office space rather than a fully distributed cost based rate as required by the CPUC.

- RTC used on outdated factor to allocate land and building costs to its nonregulated activities which understated this allocation and failed to allocate any land and building costs to its affiliates.

- The factor RTC used to allocate residual general and administrative costs to affiliates was inconsistent with the FCC's Part 64 Rules and understated the allocation to affiliates.

- RTC expensed its entire software development costs in 1999, contrary to GAAP (SOP 98-1), even thought the software would be used in future years.

These improper allocation of costs resulted in over earnings by RTC: in 1997, RTC's rate of return was 10.77% instead of the allowable 9.12%; in 1998, RTC's rate of return was 11.86% instead of the allowable 10.14%; and in 1999, RTC's rate of return was 14.60% instead of the allowable 10.55%.

Washington Case Study

In 1995, U S WEST Communications (now Qwest) requested a general rate increase of over $204 million based on traditional rate of return regulation from the Washington Utilities and Transportation Commission ("WUTC"). In 1996, the WUTC rejected the proposed rate increase and instead ordered Qwest to reduce its rates by $91.5 million.[11] Among the relevant findings and disallowances made by the WUTC were:

- Costs related to a major restructuring program were disallowed because the benefits from the program had not yet been realized and current costs far exceeded benefits.

- Corporate image advertising costs were disallowed.

- The company's proposed jurisdictional separation factors allocated excessive costs to the intrastate jurisdiction compared to historical trends.

- WUTC disallowed Qwest's bonuses, Team Awards and Merit Awards because the standards used did not benefit ratepayers, especially in light of the company's poor service quality record.

- The WUTC rejected Qwest's attempt to use depreciation rates that the WUTC had recently rejected.

- Qwest purchased procurement and warehouse services from an affiliate at prices based on the affiliate's costs plus a return. These prices, however, exceeded the market prices for such services.

- The WUTC disallowed certain R&D costs paid to affiliates, as their potential benefits to ratepayers could not be determined.

- Certain payments to Qwest's corporate parent were disallowed because they were duplicative of functions the company performed itself, were not directly related to regulated operations, or were for corporate image advertising.

- The company failed to reflect the deferred tax effects of its sale of several exchanges, sharing of excess earnings, and flow through of the tax consequences of its pension asset, resulting in a significant overstatement of its rate base.

- The company failed to synchronize the interest expense used in its federal income tax calculation with the WUTC's allowed weighted cost of debt.

Oregon Case Study

U S WEST Communications (now "Qwest") was required to submit a general rate filing to the Oregon Public Utility Commission ("OPUC") prior to expiration of its Alternative Form of Regulation ("AFOR") at the end of 1996. In its revenue requirement filing, Qwest requested an increase of $28 million. The OPUC made the following findings:[12]

- The OPUC disallowed a negative (debit) balance in Qwest's cross bar and step-by-step depreciation reserve accounts because the equipment had been retired in 1989 and a portion of the amount was due to equipment that had been used in Washington.

- Qwest failed to reflect the reduction in expenses it experienced as a result of its sale of several exchanges.

- The OPUC disallowed bonuses paid to Qwest management and executives because these bonuses were paid for achieving corporate financial goals, which benefited shareholders, not ratepayers.

- The OPUC disallowed a significant portion of Qwest's accrual for accident and damage claims as the company had accrued amounts in excess of actual payments during the test period.

- The direct costs of Qwest's reengineering program as well as extraordinary expenses incurred by the company due to the disruption the program caused in the company's operations were disallowed, as the benefits of this program had not been realized.

Overall, the OPUC ordered Qwest to reduce its revenue requirement by $97.2 million.

Idaho Case Study

In 1996, U S WEST Communications (now ("Qwest") requested a general rate increase for its price-regulated services of $38 million, a 58% increase (Qwest's request was later reduced to $15 million) from the Idaho Public Utilities Commission ("IPUC"). The IPUC staff initially recommended a rate decrease of $32 million, later adjusted the decrease to approximately $20 million (many issues were settled, typically by splitting the difference between the company and staff positions).[13]

Based upon its review of Qwest's cost study, the IPUC made the following observations:

- The company's claim for payments to affiliates was reduced because many of the payments were not for services related to the provision of basic local service.
- Telephone concession and employee recognition expenses were reduced.
- A portion of corporate image advertising was disallowed.
- The company should have amortized its restructurings/reengineering expenses over 15 years rather than in one year because the benefits of the restructuring and reductions would be realized in the future.
- Qwest agreed to forgo its proposed claim for recovery of its depreciation reserve deficiency.
- Costs related to nonregulated services, such as alarm monitoring, CPE and inmate services, were removed from the company's revenue requirement.
- A substantial portion of Qwest's software capital leases were not related to the provision of basic local service but rather supported CLASS and access services.
- The IPUC required Qwest to remove 20% of its fiber investment from its rate base because a substantial portion of its fiber was unlit.
- Because a staff audit revealed that that a portion of its central office equipment was missing (i.e., no longer in service), the company was required to reduce its central office investment.

In the end, the IPUC required the company to reduce its rates by $327,000.

Vermont Case Study

In 1999, the Vermont Public Service Board ("Board") initiated a proceeding to develop the "Vermont Incentive Regulation Plan" for Bell Atlantic-Vermont (now "Verizon"). The plan required Verizon to freeze rates for its regulated services over the five-year life of the plan while providing Verizon with pricing flexibility for competitive and new services. Prior to implementing the plan, the Board investigated Verizon's cost of service/revenue requirement to ensure that the company's existing rates were just and reasonable. In its Order adopting the plan[14], the Board made a number of adjustments to Verizon's cost of service, such as:

- The Board rejected Verizon's proposed reduction in the amortization period from 20 years (the period the Board had previously approved at Verizon's request) to 5 years, as the company had presented no compelling reason for the change.

- The company was not permitted to recover its nonrecurring OSS costs related to providing unbundled network elements as these costs had already been recovered in wholesale and retail rates.

- The Board rejected Verizon's proposed amortization of its restructuring costs and substituted an amount that also reflected Verizon's incremental savings from its restructuring program.

- Because Verizon attempted to recover a portion of its net costs of its merger with NYNEX, even though it had previously claimed that the merger would result in substantial savings, the Board rejected Verizon's cost estimate and substituted its own which reflected merger related savings.

- The Board rejected Verizon's proposed amortization of merger related severance costs, as it was a one time, nonrecurring event.

- The Board reduced Verizon's R&D costs to reflect the effect of its recent sale of Bellcore.

- Because the company could not explain why the expenses shown in its financial reports were higher than its claimed rate case expenses, it was required to reduce its cost of service by the difference.

- The company was not allowed to recover its costs of LNP implementation because the FCC had found these were interstate costs and had developed a mechanism for their recovery.

Based upon these transgressions, the Board found that Verizon was over-earning by approximately $23 million annually.

The Vermont Board has also conducted rate investigations of a number of smaller ILECs in recent years. While these proceeding have generally been resolved by stipulated settlements with no specific findings regarding the companies' revenue requirement filings, in all cases the settlement amount is less than the amount claimed by the company, in some cases considerably. For example, Northland Telephone Company of Vermont requested a revenue requirement of $3,836,681 but settled for $3,242,617, a reduction of 15.5%.[15] Similarly, Ludlow, Northfield and Perkinsville Telephone Companies requested a revenue requirement of $4,364,332 while the stipulated amount was $3,827,546, a reduction of 13.3%.[16] And, Waitsfield-Fayston Telephone Company requested $13,122,618 but settled for $11,462,618, a reduction of 12.6%.[17]

Conclusion

This brief review of state proceedings in which ILEC revenue requirement/cost of service filings were closely scrutinized strongly suggests that similar oversight of the cost support submitted by rate of return ILECs' for USF purposes would result in significant reductions in the size of the high cost fund. Rate of return carriers have strong incentives to recover as much of their costs from regulated services as possible and, not surprisingly, they act on these incentives, especially in the absence of a strong oversight function. And, with the proliferation of unregulated affiliates and services in recent years, the opportunities for cost shifting and cross-subsidization have increased.

Clearly, under rate of return regulation, ILECs have the incentive to improperly allocate their costs in a manner that allows them to realize a financial windfall. The most common improper accounting practices include the following:

- Excessive charges from unregulated affiliates to regulated operations.
- Under or no allocation of unregulated costs to unregulated operations.
- Retired plant treated as still in service.
- Depreciation and amortization costs in excess of allowed amounts.
- Understated charges from the regulated operation to unregulated affiliates.
- Accounting misclassifications.
- Overstated expenses and investment.

These improper accounting practices were uncovered in anticipated state commission proceedings that the carriers knew would result in close scrutiny of these cost studies. Because ILEC cost studies submitted to NECA and the FCC are not subject to much scrutiny, the incentive and ability for carriers to overstate their costs is significantly

higher than in the state commission cost study proceedings. These problems could be avoided by adopting a FLEC methodology as the basis for high cost funding.

Endnotes

[1] *See Rate of Return Regulation: A Failed Model for Economic Regulation* (Attachment B to this Petition). That document was also submitted as Attachment C to Reply Comments of Western Wireless Corporation, In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, June 3, 2003.
[2] In the Matter of an Audit and General Rate Investigation of JBN Telephone Company, Inc., Docket No. 02-JBNT-846-AUD, Joint Motion to Approve Stipulation and Agreement, Nov. 2002.
[3] In the Matter of an Audit and General Rate Investigation of Wilson Telephone Company, Inc Docket No. 02-WLST-210-AUD, Joint Motion to Approve Stipulation and Agreement, July 2002.

[4] In the Matter of an Audit and General Rate Investigation of Craw-Kan Telephone Cooperative, Inc., Docket No. 01-CRKT-713-AUD, Joint Motion to Approve Stipulation and Agreement, October 2001
[4] In the Matter of an Audit and General Rate Investigation of Bluestem Telephone Company, Inc., Docket No. 01-SSTT-878-AUD, In the Matter of an Audit and General Rate Investigation of Sunflower Telephone Company, Inc., Docket No. 01-SFLT-879-AUD, Joint Motion to Approve Stipulation and Agreement, April 2003.

[6] Id., Staff's Report and Recommendation on the Management Services Agreement Filed September 27, 2002, October 2002.
[7] Id., p. 15.
[8] In the Matter of an Audit and General Rate Investigation of Southern Kansas Telephone Company, Inc., Docket No. 01-SNKT-544-AUD, Non-Confidential Order Setting Revenue Requirements, September 2001.

[9] In the Matter of an Audit and General Rate Investigation of Rural Telephone Company, Inc., Docket No. 01-RLLT-083-AUD, Order Setting Revenue Requirements, June 2001.
[10] In the Matter of the Application of Roseville Telephone Company (U 1015 C) to Review Its New Regulatory Framework, Application 99-03-025, Decision, June 28, 2001.
[11] Washington Utilities and Transportation Commission v. U S WEST Communications, Inc., Docket No.UT-950200, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling, April 1996.
[12] Re. Application of U S WEST Communications for an Increase in Revenues, Docket No. UT 125, Order No. 97-171, May 19, 1997.
[13] Re. The Application of U S WEST Communications for Authority to Increase its Rates and Charges for Regulated Title 61 Services, Case No.USW-S-96-5, Order No. 27100, August 27, 1997.
[14] Investigation into an Alternative Regulation Plan for new England Telephone and Telegraph d/b/a Bell Atlantic-Vermont, Docket No. 6167, Order, March 24, 2000.
[15] Investigation into the existing rates of STE/NE Acquisition Corp d/b/a Northland Telephone Company of Vermont, Docket No. 6474, Order, October 3,2001.
[16] Investigation into the existing rates of Ludlow Telephone Company, Northfield Telephone Company, and Perkinsville Telephone Company, Docket No. 6576, Order, April 11,2002.
[17] Investigation into the existing rates of Waitsfield-Fayston Telephone Company, Docket No. 6417, Order, January 9,2001.

Rate of Return Regulation:
A Failed Model for Economic Regulation

ATTACHMENT B

to

Western Wireless Corporation's

Petition For Rulemaking To
Eliminate Rate-Of-Return Regulation
Of Incumbent Local Exchange Carriers

October 30, 2003

Rate of Return Regulation:
A Failed Model for Economic Regulation

Introduction

Rate of return regulation, in one form or another, has been used since the late nineteenth century to set and constrain the earnings and price levels for economically regulated companies.[1] In the last fifteen years, however, it has been widely supplanted by alternative mechanisms to set prices and control earnings of telecommunications carriers in the United States and many foreign countries. In particular, the FCC has adopted alternative forms of regulation to, in chronological order, set interexchange carrier rates, interstate access rates, and unbundled network element and transport and termination charges, and establish the high cost support payments for those regulated carriers serving the vast majority of customers in the U.S. State commissions have also abandoned rate of return regulation for the most part, with only six commissions continuing to use rate of return regulation for the RBOCs in their states.[2] At the FCC, the single exception to this wholesale abandonment of rate of return regulation has been its continued application to the development of the interstate access rates charged and the universal fund payments received by smaller incumbent LECs.

This paper addresses the infirmities, both theoretical and practical, of rate of return regulation that have been identified by the FCC in the past and suggests that the time has come to commence a serious and concerted effort to develop a forward looking economic cost (FLEC) model to determine the universal service receipts for rural ILECs and, potentially, their interstate access rates. If, however, as been found in the past, this is deemed impracticable, the Commission should, at a minimum, establish comprehensive auditing standards and requirements over ILEC reporting of USF costs to ensure their accuracy and compliance with the applicable Part 32, 36, 54, 64 and 65 Rules. Given the magnitude of the "unexplained" growth in payments to the ILECs[3], the potential and incentives for companies to overstate their USF eligible costs, and documented abuses of the rate of return process in the past, additional scrutiny of carriers' USF reporting is essential to ensure the integrity of the high cost USF mechanisms.

The FCC's Rejection of Rate of Return Regulation

For over fifteen years, the FCC has been evaluating the efficacy of rate of return regulation as a tool to achieve its regulatory objectives and has found it wanting in virtually all instances. While it is not the intent of this paper to provide an exhaustive history of the FCC's findings and conclusions on rate of return regulation, it is worth noting some of the specific infirmities the Commission has identified in past proceedings because these remain relevant to this day. In particular, many of the Commission's specific concerns over the incentives created by and the administration of a rate of return regulatory regime have, as will be discussed in a later section of this paper, been borne out by instances in which companies have been found to have manipulated the process for their benefit.

The first, and most comprehensive, evaluation of rate of return regulation by the Commission was conducted in the Price Cap proceeding in the late 1980s[4], in which it replaced rate of return with price cap regulation as the mechanism for overseeing the interstate rates charged, initially, by AT&T and later the large ILECs. In the Notices and Orders in this proceeding, the Commission laid out in considerable detail its findings on the problems created by the incentives and administration of a rate of return regulatory regime. Principal among these were:

- Incentive to Pad Costs - "(R)ate of return regulation provides regulated firms with very strong incentives to pad their rates, for essentially two reasons. First, as a profit-maximizer, the firm is led to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base. This is commonly known as the Averch-Johnson effect…of rate of return regulation. Second, since all operating expenses are included in a firm's revenue requirement under rate of return, management has little incentive to minimize operating costs. This is commonly known as 'X-inefficiency'. The firm's shareholders profit from the first phenomenon and the benefits of the second redound to the firm's management. In both cases, however, consumers suffer because these distorted incentives increase the cost of doing business –and thus the rates consumers must pay for service"[5] The impact of this was clearly demonstrated by the fact that, in 1990, "the Common Carrier Bureau has been able to identify and disallow over $2.7 billion in LEC access charges since 1985."[6]

- Lack of Incentives to Innovate - "The distorted efficiency incentives established by rate-of-return regulation also may have a negative effect on innovation. Clearly, rate-of-return establishes no incentive to 'do the same old thing a better way' – for example, by providing the same service at lower cost – because a carrier's reward for such innovation is a reduction in its dollar earnings. Such regulation may well have similar effects on incentives to produce new products and services…..The limit on the ability of a carrier to earn returns on risky investments comparable with such risks, together with the potential that an unsuccessful project will result in cost disallowance, provide a reasonable basis to conclude that carriers have reduced incentives to undertake such risks under rate-of-return regulation. At best, rate-of-return regulation is 'passive' vis-à-vis innovation, neither fostering it nor encouraging it. We think the public interest is better served by the adoption of regulatory methods more attuned to stimulating innovation."[7]

- Potential for Cross-Subsidization - "Carriers subject to this (rate of return) regulatory approach have an incentive to shift some of the costs of providing unregulated competitive services to regulated services, where they can be recovered from ratepayers rather than the consumers of regulated services who rightfully bear these costs. In so doing, the carrier can increase its profits and simultaneously disadvantage its competitors."[8]

  "(W)e disagree with those who suggest that cross-subsidization can be addressed easily under rate-of-return regulation through 'active and consistent oversight'. Such claims understate the difficulties inherent in oversight activities and ignore the long history of these difficulties. Concerns about different kinds of cross-subsidization have, in a very real sense, dominated federal telecommunication regulation since the advent of

competition in the 1950s, and were determined to be so intractable as to justify the draconian solution of divestiture of the Bell System. During the past few years, of course, we have implemented a number of regulatory techniques to discourage cross-subsidization between regulated and unregulated activities and improve our oversight capabilities….While these steps will act as a strong deterrent to cross-subsidization activities, our policies and programs can do no more than deter and attempt to detect such activities, they cannot eliminate the powerful incentive that rate-of-return regulation establishes to engage in cross-subsidization."[9]

- Administrative Transparency - "(A)dministering rate of return regulation in order to counteract these incentives is a difficult and complex process, even when done correctly and well….(S)uch regulation is built on the premise that a regulator can determine accurately what cost are necessary to deliver service. In practice, however, a regulator may have difficulty obtaining accurate cost information as the carrier itself is the source of nearly all the information about its costs. Furthermore, no regulator has the resources to review in detail the thousands of individual business judgments a carrier makes before it decides, for example, to install a new switching system."[10]

There is no evidence to indicate, and considerable evidence to the contrary, that rate of return regulation as applied to establish universal service funding and interstate access rates for the rural ILECs avoids the pitfalls identified by the Commission over a decade ago. The incentive to pad costs, lack of incentives to innovate, potential for cross-subsidization and lack of transparency of the underlying cost data are as much problems today as they were then.

In subsequent proceedings, the Commission has reaffirmed its rejection of rate of return regulation , albeit without the detailed analysis it undertook in the Price Cap proceeding. In the Local Competition proceeding, which established the pricing standards for unbundled network elements and interconnection, the Commission found that:

> (A) cost-based pricing methodology based on forward-looking economic costs….is the approach for setting prices that best furthers the goals of the 1996 Act. In dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market-determined prices and forward-looking economic costs….. New entrants should make their decisions whether to purchase unbundled elements or build their own facilities based on the relative economic costs of these options. By contrast, because the cost of building an element is based on forward-looking economic costs, new entrants investment decisions would be distorted if the price of unbundled elements were based on embedded costs.[11]

The Commission went on to elaborate:

> We are not persuaded by incumbent LEC arguments that prices for interconnection and unbundled network elements must or should include any difference between the embedded costs they have incurred to provide those elements and their current economic costs. Neither a methodology that establishes prices for interconnection and access to network elements directly on the costs reflected in the regulated books of account, nor a

> price based on forward-looking costs plus an additional amount reflecting embedded costs, would be consistent with the approach we are adopting. The substantial weight of economic commentary in the record suggests that an 'embedded cost'-based pricing methodology would be pro-competitor—in this case the incumbent LEC—rather than pro-competition. We therefore decline to adopt embedded costs as the appropriate basis of setting prices for interconnection and access to network elements.[12]

In this proceeding, unlike the Price Cap and Universal Service (discussed below) proceedings, no exception to forward looking economic cost (FLEC) based pricing requirements was made for rural ILECs.

Finally, in establishing a universal service support mechanism for non-rural carriers, the Joint Board (later affirmed by the Commission) again found that the application of FLEC using a proxy model to establish support levels would best meet the Act and the Commission's universal service objectives. The Joint Board stated:

> We conclude that setting support at forward-looking economic cost levels will allow us to construct a universal service support mechanism that will preserve and advance universal service and encourage efficiency. Competitive firms will provide service using an approximately efficient level of resources because, in those instances when revenues are not sufficient, the support mechanism will provide the additional funds required to maintain service. In principle, using cost estimates generated by proxy models is a reasonable technique for determining forward-looking costs. Proxy models, because they are not based on any individual company's costs, provide a competitively neutral estimate of the cost of providing supported services[13]

In this proceeding, both the Joint Board and Commission indicated their intent eventually to base universal service support for rural carriers on forward-looking costs, but, because "the proposed models could not at this time precisely model small, rural carriers' cost"[14], the Commission would continue to use a slightly modified version of the existing embedded cost-based mechanisms until January 1, 2001. The Commission found that this would provide sufficient time to develop a model that would accurately predict rural carriers' forward-looking economic costs. Nevertheless, the Commission fully recognized the problems with continuing to use an embedded cost mechanism for rural carriers, stating:

> We find that the current support mechanisms neither ensure that ILECS are operating efficiently nor encourage them to do so. Indeed, by guaranteeing carriers recovery of 100 percent of all loop costs in excess of 150 percent of the national average loop cost, the current high cost funding mechanisms effectively discourage efficiency. Thus, we agree with CSE that calculating high cost support based on embedded cost is contrary to sound economic policy. We conclude that basing support on forward-looking economic cost or perhaps competitive bidding will require telecommunications carriers to operate efficiently and will facilitate the move to competition in all telecommunications markets.[15]

The Joint Board then established the Rural Task Force (RTF) to recommend modifications to the high cost support mechanisms for rural carriers. The RTF found that significant anomalies resulted when the FCC' synthesis (proxy) model was applied to rural carriers, including large differences between model results and actual data for line counts, wire center areas, route miles of outside plant, type of outside plant construction, COE investment and other costs.[16] As a result, the RTF recommended that the Commission continue to use a modified embedded cost mechanism until 2006 to allow time to develop a long term rural mechanism that functions efficiently, is better coordinated with the non-rural mechanism, and effectively targets support to rural carriers serving the highest cost areas. The Commission subsequently adopted the RTF's recommendation.[17]

Although Western Wireless will continue to support maintaining the status quo until 2006, the Company believes it is time for the Commission and the Joint Board to begin a concerted effort to develop a FLEC model that effectively and accurately estimates the efficient cost of providing supported services for rural carriers. This effort could also involve a review of the existing synthesis model used for non-rural carriers and the inclusion of wireless costs to ensure a coordinated approach to universal service funding for all segments of the industry. The development of a new FLEC model should commence as soon as possible because the process will inevitably be controversial and require considerable time and resources (similar to the process of developing the synthesis model). However, Western believes that, due to advances in modeling, mapping and geocoding techniques since the development of the synthesis model, the problems in the application of that model to rural carriers identified by the RTF can potentially be overcome.[18]

As was discussed above, the Commission has fully evaluated the effectiveness of and incentives created by rate of return regulation and consistently found it wanting. These problems have not been cured by the passage of time. As will be discussed in the next section of this paper, in those few publicly documented instances in which the Commission (or the NECA) has been compelled to fully investigate the data reported by rate of return carriers, they have almost inevitably found serious problems. None of this is surprising and provides further evidence of the need to abandon rate of return regulation for all telecommunications carriers.

Manipulation of the Rate of Return Process

Unsurprisingly, carriers frequently act on the incentives created by rate of return regulation. This is especially true with respect to interstate intercarrier compensation received by ILECs under rate of return mechanisms, such as access charges, settlements, and universal service funding. As a mechanism for collecting revenue, intercarrier compensation has a number of advantages over the provision of retail services, especially for smaller ILECs: the process is well established and operates relatively automatically (through NECA, USAC and CABS); there are no marketing costs; revenues are relatively unaffected by a company's own customers' demand elasticities; historically (at least until the WorldCom and Global Crossing bankruptcies), there were very low levels of uncollectibles; and, the level of scrutiny of reported costs is relatively low (especially in comparison to the scrutiny accorded in state rate case and show cause proceedings). Consequently, rate of return ILECs have every incentive, and in many cases the

ability, to maximize their revenues from interstate access services and the universal service fund and it appears they have done so.

There are a number of indicators that suggest rate of return ILECs have engaged in, or attempted to engage in, interstate revenue maximization over the years. For example, as was noted above, the FCC in 1990 indicated that they had disallowed over $2.7 billion in LEC access charges since 1985 under rate of return regulation.[19] In addition, in its Comments, Western identified an increase of over $191 million in the ILEC portion of the USF since 1999 that cannot be explained by regulatory changes (MAG, CALLS and RTF) implemented during that period.[20] Further, AT&T, in a recent ex parte filing, showed that rate of return carriers filing Form 492 Reports had experienced interstate overearnings of over $218 million in the 2001-2002 period, following overearnings of approximately $92 million in 1999-2000 and $121 million in 1997-1998.[21] These indicators clearly show that carriers have acted on the incentives created by rate of return regulation and, apparently, increasingly successfully in recent years.

There have been a number of instances in the relatively recent past in which rate of return carriers have been found to have violated or egregiously manipulated the Commission's accounting and costing rules in order to maximize their interstate revenues. While Western believes that these examples merely represent the tip of the iceberg, they are illustrative of ways in which carriers have acted on the incentives created by rate of return regulation. They also provide some guidance on areas in which the Commission could enhance its oversight of rate of return carriers until it can implement a FLEC model for determining all carriers' universal service receipts.

Virgin Islands Telephone Company (VITELCO) Interest Expense

In 1990, VITELCO filed a Request for Declaratory Ruling with the Commission to resolve a dispute with NECA (of which it was a member) over the treatment of interest expense in its cost study. Atlantic Tele-Network Company had purchased VITELCO from ITT and borrowed approximately $100 million to finance the purchase, of which $60 million was recorded on VITELCO's books. VITELCO took the position that it should not be required to deduct the interest expense from its return allowance for the purpose of determining its federal income tax expense for ratemaking purposes (which would decrease its interstate revenue requirement). The Commission, however, disagreed, noting that the company's regulated plant was pledged as security for the loan and upheld NECA's interpretation of this issue.[22]

Direct Assignment under Part 36

When the Commission replaced the Part 67 jurisdictional separations procedures with Part 36 in 1987,[23] it allowed for the direct assignment of certain plant costs to the interstate or intrastate jurisdiction if the facility was used exclusively to provide interstate or intrastate services. A number of carriers began to use direct assignment quite extensively, most of which were direct assignments to interstate services, and the Commission was forced to clarify that it intended a relatively limited role for direct assignment in the separations process.[24] In particular, the Chesapeake and Potomac Telephone Company had attempted to construe an allocation of trunk testing expense it had developed as a permitted direct assignment and a number of carriers

directly assigned portions of corporate operations expense rather than use the prescribed allocation factor. In each of these instances, the Commission rejected the carriers' position as a misinterpretation of Part 36.[25]

NECA Audits of the RBOCs' Common Line Pool Reporting

The Commission had found that the RBOCs had made some unusually large adjustments to the NECA Common Line (CL) Pool in December 1988 (shortly before they were permitted to exit the Common Line Pool), adjustments apparently encouraged by RBOC members of the NECA Board. As a result, the Commission ordered NECA to commission an audit of the RBOCs' reported adjustments to the CL Pool from January 1988 through March 1989. The results of this audit revealed misstatements or miscalculations of interstate costs and revenues during this period of $37.8 million for NYNEX, $23.2 million for Bell Atlantic, $22.8 million for Ameritech, $16.2 million for US West, $9.7 million for Southwestern Bell, $6.2 million for Bell South and $3.4 million for Pacific Bell. Most of these misstatements were found to have benefited the companies at the expense of interstate ratepayers. The audit uncovered a wide range of violations of Parts 32, 36, 64, 65 and 69 of the Commission's Rules and related policies.[26] Subsequently, each of the RBOCs entered into Consent Decrees with the Commission which required the carriers to, depending on the individual carrier, make exogenous price cap adjustments of up to $13.7 million (Bell Atlantic), conduct audits of their internal controls and/or correct their accounting practices to conform to the Commission's Rules.[27]

1997 Annual Access Tariff Filings-Cash Working Capital

In investigating the 1997 annual access tariff filing of several rate of return carriers, the Commission identified significant problems with the lead-lag studies used by these carriers to develop the cash working capital component of the rate base. The Commission had established a 15-day standard allowance (i.e. revenues are collected, on average, 15 days after the payment of cash expenses) which, when multiplied by average daily cash expense, produces the rate base cash working capital allowance. Carriers are, however, allowed to use a longer net lag if supported by a properly performed lead-lag study.[28] The cash working capital of four carriers was based on net lag days far in excess of the standard allowance, ranging from 46 days for Concord Telephone Company to 71.8 days for Puerto Rico Telephone Company. The Commission's review of the companies' lead lag studies revealed a raft of problems, including large out-of-period or retroactive adjustments, outdated studies that failed to reflect current operations, and inconsistent study periods. Consequently, the Commission ordered all four carriers to revert to the 15-day standard allowance and provide refunds with interest.[29]

ACS of Anchorage Traffic Factors

In 2000, GCI (an Alaskan IXC and CLEC) filed a complaint alleging that ATU, ACS' predecessor, had been counting ISP traffic as interstate, rather than intrastate, and counting only a single dial equipment minute (DEM) rather than two for intraoffice local calls in developing its interstate traffic sensitive access rates. This was in direct contravention of established Commission policies and resulted in ATU earning a rate of return on its traffic sensitive services of over 32%, far in excess of its allowed rate of return of 11.25%. The Commission ruled

against ATU and awarded damages with interest.[30] Subsequently, in December, 2001, in its tariff filing in response to the MAG Order, ACS of Anchorage continued to use as its baseline revenue requirement for this filing, the same revenue requirement it had used in 2000 i.e. based on the traffic factors disallowed by the Commission. Consequently, the Commission rejected ACS' filed rates as unjust and unreasonable to the extent they were based on the unlawful traffic factors.[31]

Moultrie Independent Telephone Company High Cost Reporting

In 1997, Moultrie Independent Telephone Company, a small rural ILEC in Illinois, transferred ownership of many of its non-loop assets to an affiliate and then leased them back at cost to the telephone company, treating the lease cost as an operating expense and excluding the asset costs from the rate base. When Moultrie submitted its 1997 cost study to the NECA, this treatment resulted in its high cost loop fund payments going from $15 per year per loop to $433, as Moultrie's accounting treatment resulted in a much larger proportion of its operating expenses being assigned to the loop element. NECA rejected Moultrie's cost study on the ground that it violated the Part 36 requirement that, when substantial amounts of property are leased back to a company by an affiliate for cost study purposes, the property should be treated as if it is owned by the telephone company. The Commission upheld NECA's interpretation and ordered Moultrie to resubmit its cost studies reflecting the proper treatment of the sale-leaseback transaction.[32]

Clearly, carriers have acted on the incentives created by rate of return regulation in order to maximize their interstate USF and access revenues. The examples cited above likely represent only those instances in which the attempt to manipulate the process was sufficiently blatant that the NECA, interveners and/or the Commission stepped in to address and remedy the violations. Other instances likely either remain undetected or are dealt with through the NECA/USAC oversight functions. Unfortunately, the results of these organizations' audits or reviews of carriers' USF related data reporting are not publicly available, so Western is unable to evaluate the effectiveness of these oversight functions.

Enhancement of the USF Oversight Process

Western strongly believes that high cost support for all carriers should be based on an appropriately designed FLEC model to eliminate the incentives to pad costs, enhance efficiency incentives, eliminate the potential for cross-subsidization and render the underlying input data transparent to all parties, not just the ILECS. Nevertheless, Western commits to maintaining the status quo through 2006 and recognizes that such a model will take at least that long to develop. Until that time, or if the effort to develop a FLEC model for rural carriers is ultimately deemed infeasible, Western believes that enhanced oversight of the cost and line count data submitted by ETCs may go a long way towards stemming the growth of the high cost fund.

A number of factors suggest that stronger oversight of the high cost fund is necessary to enhance the transparency of the process and limit the potential for abuse:

- While NECA does review rate of return carriers' cost study and high cost fund submissions, the scope and outcomes of these reviews are not made public. Consequently, it is not possible for outside parties to evaluate the effectiveness of these reviews and their effect on carriers' compliance with the Commission's Rules and policies.

- NECA simply does not have sufficient staff to conduct stringent reviews/audits of all carriers' cost data. According to its web site, NECA has only 48 "Member Services" staff, the personnel responsible for cost study reviews, in its seven regional offices. Because these NECA personnel also have other responsibilities and over 1,500 companies[33] receive high cost support, it would be physically impossible for NECA to conduct comprehensive reviews of all or even a significant number of carriers' cost data. Further, USAC had only seven internal auditors and spent only a little over a million dollars in 2002 on external audit services for oversight of all the USF programs, not just high cost.[34]

- Given the composition of its Board of Directors, it is unclear whether NECA is sufficiently independent of rate of return ILEC interests to support a strong oversight function. Of its fifteen member Board of Directors, six are from Subset Three, representing the smaller ILECs, the two Subset Two Directors, representing the midsize ILECs, are from rate of return carriers that receive considerable USF (Century and TDS) and, of the five outside Directors, two are former RUS administrators and one is from an affiliate of a rate of return ILEC.

- While the well publicized problems with the E-Rate programs have not yet spilled over into the high cost fund programs, these problems demonstrate that participants do act in the incentives created by these programs and that the existing oversight functions have not been adequate to curb the potential for abuse.

In order to enhance oversight of the high cost programs, Western recommends that the following programs and policies be put in place:

- Carriers' cost studies and other data submissions supporting their high cost funding should be made publicly available. Inasmuch as USF is essentially a form of public funding, the basis for this funding should be a matter of public record. The data available would include Part 36 and 69 cost studies and supporting workpapers, the company's Part 64 Manual and resulting regulated/nonregulated cost allocations, details of all affiliate transactions involving the regulated telephone operation, financial statements for the telephone company and all its affiliates, LSS and HCL calculations, and line counts. As this is similar to the type of data provided by rate of return carriers subject to the FCC's Tariff Review Process and in state rate cases, there is ample precedent for making this type of data available for public scrutiny. Carriers would have the opportunity to request confidentiality for any data considered competitively sensitive. Given that many of the attempts to manipulate the rate of return process discussed in the previous section were first identified by parties other than the Commission or NECA, this expansion of the universe of "overseers" would facilitate the identification of potential instances of abuse.

- The results of any reviews of cost studies or other data submissions involving high cost funding conducted by NECA or USAC over the past three years should be made publicly available. This would enable outside parties to evaluate the effectiveness of the existing oversight process. Again, there is precedent for releasing such information, for example, the FCC's release of the results of its audits of the RBOCs' continuing property records ("CPRs") in 1999.[35]

- If, as Western suspects, review of the information provided pursuant to the above recommendations indicates that the existing oversight processes are inadequate to detect many instances of abuse, an enhanced audit/review process should be put in place. This process should have the following features:

    - Audits of the data underlying the high cost submissions of every carrier receiving "substantial amounts of USF would be conducted every three years, more frequently if there were a significant increase in a company's year over year funding requests. The audits would encompass the previous three years of data submissions.

    - The audits would be conducted by truly independent firms (*i.e.,* public accounting firms, *not* consulting firms with other relationships with rural ILECs) following a scope of work approved by the Commission.

    - To ensure independence, the audit firm(s) would be selected and supervised by the FCC and/or USAC.

    - The audits would be conducted on relatively short notice to ensure company records weren't manipulated or falsified.

    - Companies would be required to provide full access to their books and records.

    - The results of the audits would be made publicly available.

    - Companies found to have violated the Commission's Rules and policies in their submissions would not only be required to repay the amount of excess funding received but would be subject to fines for significant violations e.g. claiming more than 110% of what they were due. In truly egregious cases, the carrier would become ineligible for future funding.

Western believes these audits should be as comprehensive as possible to ensure the integrity of the high cost funding process. While it is not the intent of this paper to fully define the scope of work for the audit process, at least the following types of issues should be reviewed:

- Loop Counts – Are all loops classified accurately (especially those between the switch and ISPs and ISDN-PRI versus digital trunk lines)? Are subscriber line charges assessed correctly?

- Investment Classifications – Are only facilities providing service in the study area reflected in reported costs? Do the company's CPRs and circuit counts support the assignment of C&WF between the subscriber, exchange trunk, interexchange and host/remote categories? Are remote switches and concentrators appropriately classified according to RAO Letter 21? Are the costs of Class 4/5 switches accurately allocated between the tandem and local switching categories? Are DSL costs fully captured and assigned to the appropriate categories and jurisdiction based on the speed and type the services provided? Are all building costs, especially CO buildings, treated as such? Do direct assignments of investments or expenses conform to Commission policies?

- Part 64 – Does the company maintain and follow an up-to-date Part 64 Manual? Does it conform to the Commission's prescribed cost allocation hierarchy? Are adequate internal controls in place? Is the general allocator appropriately developed and applied?

- Affiliate Transactions – Are only recoverable costs under the Part 65 Rules included in management fees or other charges from unregulated affiliates (excluding items such as acquisition adjustments, lobbying costs, etc.)? Are these charges booked to the correct Part 32 accounts for the functions provided by the affiliate? Do any sale and lease back arrangements reflect the Part 36 substantial property requirement?

- Accounting Classifications – Are costs, especially those that would be subject to the HCL Fund corporate cap, booked to the correct Part 32 accounts? Is interest expense on debt secured by the assets of the telephone company shown on the regulated books and reflected in calculation of federal and state income tax allowances? Is interest during construction calculated correctly and reflected as a revenue requirement offset?

- Cash Working Capital – If the company does not use the 15-day standard allowance, does it have a current lead-lag study that follows the Commission's prescribed policies and practices? Do the minimum bank balances reflect only compensating balances?

Western believes that independent audits of company reporting practices that address issues such as those identified above would produce high cost fund savings far in excess of the cost of the audits themselves.

Conclusion

The Commission has evaluated rate of return regulation in a variety of contexts over the last fifteen years and consistently found that it fails to meet its regulatory objectives. The incentive to pad costs, lack of incentives to innovate, potential for cross-subsidization and lack of transparency remain fundamental and intractable problems that have defied solution. And, as the examples provided in this paper demonstrate, companies have frequently acted on the incentives created and attempted to manipulate the system to their benefit. Adoption of an effective FLEC model to develop all carriers' universal service costs and funding would enable the Commission to abandon the failed rate of return mechanism once and for all. Until such time as a reliable and accurate FLEC model can be developed, or if that proves infeasible, until a viable alternative can

be developed, more stringent oversight of the high cost funding and reporting process should be instituted as proposed in this paper.

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1. Rate of return regulation is also referred to as rate base/rate of return, revenue requirement and embedded cost (at least since the abandonment of the fair value standard of asset valuation) regulation. These terms will be used interchangeably herein.

2. See map, *Retail Regulation of Local Telecommunications Providers*, NRRI, January 2003.

3. See *The Legal and Historical Background of the Federal Universal Fund System,* Hogan & Hartson, Attachment A to Western Wireless' Comments in this proceeding.

4. Re. *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313 ("Price Caps").

5. Price Caps, Further Notice of Proposed Rulemaking, FCC 88-172, Para. 39 (1988).

6. Price Caps, Second Report and Order, FCC 90-314, Para. 234 (1990).

7. Price Caps, Further Notice, Op Cit. Para. 46-47

8. Id., Para. 48.

9. Id., Para. 52.

10. Price Caps, Report and Order and Second Further Notice of Proposed Rulemaking, FCC 89-91, Para. 31 (1989).

11. Re *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket No. 96-98, FCC 96-325, Para. 620 (1996).

12. Id., Para.705

13. Re. *Federal-State Joint Board on Universal Service*, Recommended Decision, CC Docket No. 96-45, FCC 96J-3, Para. 276 (1996)

14. Re. *Federal-State Joint Board on Universal Service*, Report and Order, CC Docket No. 96-45, 12 FCC Rcd 8776, Para. 291 (1997)

15. Id, Para. 292.

16. Rural Task Force, White Paper No. 4, A Review of the FCC's Non-Rural Universal Service Fund Method and the Synthesis Model for Rural Telephone Companies, September 2000

17. *Federal State Joint Board on Universal Service, and Multi-Association Group Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Fourteenth Report and Order, Twenty-Second Order on Reconsideration, and Further Notice of Proposed Rulemaking in CC Docket No. 96-45, and Report and Order in CC Docket No. 00-256, 16 FCC Rcd 11244 (2001)

18. See *Proposal for a Competitive and Efficient Universal Service High Cost Funding Model/Platform*

James Stegeman, Attachment I to Western's Comments

19. See fn 6

20. See fn 3, p. 6.

21. AT&T, Notice of Ex Parte Filing, CC Docket Nos. 00-256, 96-45, 98-77 and 98-166, May 9,2003, Exhibit 1.

22. Re Virgin Islands Telephone Company, Memorandum Opinion and Order, AAD 90-19, DA 90-143 (1990), DA 91-707 (1991), FCC 92-504 (1992).

23. Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket No. 86-297, *Recommended Decision and Order*, 2 FCC 2d. 2582 (1987).

24. Letter of Interpretation, Clarification of the Role of Direct Assignments in the Jurisdictional Separations Process, AAD 91-48, 6 FCC Rcd 5068 (1991).

25. The Chesapeake and Potomac Telephone Company, Petition for Wavier of the Common Carrier Bureau's Letter of Interpretation Dated August 21, 1991, *Memorandum Opinion and Order*, 7 FCC Rcd 3622 (1991).

26. Re. Ameritech Operating Companies, Bell Atlantic Operating Telephone Companies, etc., *Orders to Show Cause*, AAD 93-146-152, FCC 95-72-78 (1995).

27. Re. Ameritech Operating Companies, Bell Atlantic Operating Telephone Companies, etc, *Consent Decree Orders,* AAD 93-146-152, FCC 96-412-418 (1996).

28. Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Bases and Net Income of Dominant Carriers, *Order on Reconsideration*, 4 FCC Rcd 1697 (1989)(*Rate Base Component Reconsideration Order*).

29. Re. 1997 Annual Access Tariff Filings, Memorandum Opinion and Order, CC Docket No. 97-149, FCC 97-403, Para. 208-226 (1997).

30. Re. General Communications, Inc. v. Alaska Communications Holdings, Inc. d/b/a ATU Telecommunications, *Memorandum Opinion and Order*, EB-00-MD-016, 16 FCC Rcd 2834 (2001)

31. Re. Tariffs Filed by ACS of Anchorage, Inc, and the National Exchange Carrier Association, *Memorandum Opinion and Order,* CC Docket No. 02-36, FCC 02-160 (2002).

32. *Moultrie Independent Telephone Company, Motion for Stay of Part 69.605(a) of the Commission's Rules and Petition for Declaratory Ruling, Request for Waiver of Part 36 of the Commission's Rules, Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Order, FCC 01-292 (Oct. 5, 2001) (*Moultrie Order*).

33. USAC 2002 Annual Report

34. Id.

35. News Release, FCC RELEASES AUDIT REPORTS ON RBOCs' PROPERTY RECORDS, Report No. CC 99-3, February 25, 1999